



Economic &

Social Affairs

The Twin Challenges of Reducing Poverty and Creating Employment



UNITED NATIONS

Division for Social Policy and Development

Department of Economic and Social Affairs

The Twin Challenges of Reducing Poverty and Creating Employment

This publication is based on presentations made at two Expert Group Meetings on “Poverty Eradication” and “The Challenge of Building Employment for a Sustainable Recovery” which were organized by the Division for Social Policy and Development of the Department of Economic and Social Affairs of the United Nations (UN/DESA) in collaboration with the International Labour Organization (ILO) in Geneva, Switzerland in June 2011.



United Nations

New York, 2013

Department of Economic and Social Affairs

The Department of Economic and Social Affairs of the United Nations Secretariat is a vital interface between global policies in the economic, social and environmental spheres and national action. The Department works in three main interlinked areas: (i) it compiles, generates and analyses a wide range of economic, social and environmental data and information on which States Members of the United Nations draw to review common problems and to take stock of policy options; (ii) it facilitates the negotiations of Member States in many intergovernmental bodies on joint courses of action to address ongoing or emerging global challenges; and (iii) it advises interested Governments on the ways and means of translation policy frameworks developed in United Nations conferences and summits into programmes at the country level and, through technical assistance, helps build national capacities.

Notes

The views expressed in the present publication are those of the authors and do not imply the expression of any opinion on the part of the Secretariat of the United Nations, particularly concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries. The assignment of countries or areas to specific groupings is for analytical convenience and does not imply any assumption regarding political or other affiliation of countries or territories by the United Nations. The designations “developed” and “developing” are intended for statistical and analytical convenience and do not necessarily express a judgement about the stage reached by a particular country or area in the development process.

ST/ESA/342

United Nations publication

Copyright © United Nations, 2013

All rights reserved

This publication is available for download at: <http://www.un.org/esa/socdev/documents/employment/twinchallenges.pdf>

Preface

The fallout of the global financial and economic crisis, on the heels of a rapid rise in food and fuel prices, slowed down global progress in poverty eradication and led to a severe jobs crisis. In June 2011, the Division for Social Policy and Development of the Department of Economic and Social Affairs of the United Nations (UN/DESA), in collaboration with the International Labour Organization (ILO), organized two Expert Group Meetings, on “Poverty Eradication” and “The Challenge of Building Employment for a Sustainable Recovery”, in Geneva, Switzerland. The meetings brought together specialists to undertake a review of progress in eradicating poverty and to analyse policy responses to the global jobs crisis in different countries and regions of the world. This volume includes some of the papers presented at the Experts Group Meetings.

The articles in the present book make an important contribution to efforts to analyse the impact of various policies on poverty eradication and employment creation. These policies range from making sustained investments in the social sectors (education, health and social protection), in agriculture and in strengthening the role of the State in development. The goal of generating full employment and decent work opportunities for all requires a reorientation of macroeconomic policies from the current heavy emphasis on short-term stability to the promotion of sustained, inclusive and equitable growth. Overall, the volume emphasizes the need to rethink public policy, beyond poverty reduction strategies and labour market programmes, and to reorient macroeconomic policy towards the reduction of poverty and employment creation. It stresses the need for the integration of social and economic policies to enable the attainment of people-centred development outcomes.

Special thanks go to Bibi S. Khan and Julie Pewitt, who worked diligently with Amson Sibanda (Part I) and Marta Roig (Part II) to substantially edit the chapters of this volume, to Donald Lee for his leadership during the Expert Group Meetings and to Jomo Kwame Sundaram for his guidance. DESA would also like to thank José Manuel Salazar-Xirinachs and his team at the ILO for their contributions. This book would also not have been possible without the excellent contribution of all of the experts who participated in the two Expert Group Meetings, and the ongoing cooperation of the authors of the chapters of this publication.

Daniela Bas, Director,
Division for Social Policy and Development, UN/DESA,
New York, December 2013

CONTENTS

	<i>Page</i>
Preface	5
Contributors	12
Introduction - Donald Lee, Marta Roig and Amson Sibanda	15
Part I: Poverty eradication	21
Chapter 1. Poverty matters - Jomo Kwame Sundaram	23
Chapter 2. Education and the roles of the State and the market in poverty eradication - Minquan Liu	37
Chapter 3. Governance, development and poverty eradication - Goran Hyden	55
Chapter 4. Agriculture, rural livelihoods and poverty eradication: some policy lessons from the food price crises - Bettina Prato	69
Chapter 5. Sustaining effective anti-poverty programmes beyond transformation: challenges and way forward - Julian May	87
Part II: The challenge of building employment for a sustainable recovery	103
Chapter 6. Employment matters - Jomo Kwame Sundaram	105

Chapter 7.	123
Macroeconomic policy after the global recession of 2008-2009: a development perspective - <i>Iyanatul Islam</i>	
Chapter 8.	141
The distributional effects of fiscal austerity - <i>Laurence Ball, Davide Furceri, Daniel Leigh and Prakash Loungani</i>	
Chapter 9.	159
Achieving full, productive and freely chosen employment for young people - <i>Steven Miller</i>	
Chapter 10.	175
Financing social and labour market policies in times of crisis and beyond - <i>Katja Hujo</i>	
Chapter 11.	199
Crisis-driven labour market programmes: the experience of Latin America and the Caribbean - <i>Jacqueline Mazza and Danilo Fernandes Lima da Silva</i>	
Chapter 12.	215
Employment challenges in the Middle East and North Africa - <i>Azita Berar</i>	

List of tables

Table 9.1	163
Youth share of working age population	
Table 10.1	181
Mobilizing revenues—timing and conditions	
Table 10.2	187
Labour market policies and potential funding sources	
Table 10.3	187
Social policy and labour market responses to the crisis, selected countries (2008-2010)	
Table 12.1	221
Employment-to-population rate by gender	

Table 12.2	221
Youth labour force participation rates, 2000, 2010 and 2015	
Table 12.3	221
Youth employment, several indicators, 2000, 2008 and 2011, and adult employment-to-population ratio	
Table 12.4	224
Unemployment rate by gender	
Table 12.5	226
Annual real GDP growth rates, selected countries	
Table 12.6	227
Trends in productivity and wages, selected countries	

List of figures

Figure 1.1	24
Global and regional trends in extreme poverty, 1981-2010	
Figure 1.2	25
Changing regional shares in extreme poverty, 1981-2010	
Figure 2.1	42
A two-sector long-run model of labour markets for skilled and unskilled labour	
Figure 3.1	62
Types of poverty manifestations depending on governance context	
Figure 7.1	129
The “fiscal diamond”	
Figure 7.2	130
Public investment in LDCs, Africa and Asia, 1970-2008	
Figure 8.1	144
Gini coefficient in advanced economies	
Figure 8.2	146
Cumulative change in the Gini coefficient before and after consolidation measures	

Figure 8.3	146
The effects of fiscal consolidation on inequality	
Figure 8.4	150
The effects of fiscal consolidation on inequality—robustness check for different sets of controls	
Figure 8.5	152
The effects of fiscal consolidation on inequality—robustness check for different lags	
Figure 8.6	154
The effects of fiscal consolidation on inequality—spending versus based measures	
Figure 8.7	156
The effects of fiscal consolidation on wage income	
Figure 10.1	176
Fiscal stimulus plans	
Figure 10.2	179
Fiscal transmission channels	
Figure 10.3	185
Revenue type, distribution and social relations	
Figure 10.4	191
Latin America and the Caribbean: Coverage of CCT and related public expenditure	
Figure 12.1	216
Total population in MENA, 1950–2100 (millions)	
Figure 12.2	218
Labour force, 1980-2020 (millions)	
Figure 12.3	218
Gender gap in labour force participation, 2000 and 2010	
Figure 12.4	222
Youth unemployment rate by region, 1991-2012	
Figure 12.5	223
Youth unemployment rate by gender, 2000 and 2008-2010	

Figure 12.6	223
Unemployment rate by gender, selected countries, latest year available (percentage)	
Figure 12.7	228
Working poverty at US\$ 2 a day, share in total employment	
Figure 12.8	228
Working poverty at US\$ 1.25 a day, share in total employment	
Figure 12.9	229
Labour productivity—output per worker (constant 2005 international dollars), 1999-2012	
Figure 12.10	229
Employment by sector, selected countries (percentage)	
Figure 12.11	230
Employment share by sector in the Middle East	
Figure 12.2	230
Employment share by sector in North Africa	
Figure 12.13	233
Declining wage growth in Algeria and Egypt	

List of boxes

Box 7.1	131
Financing the Millennium Development Goals and the Social Protection Floor	
Box 7.2	133
The relationship between debt relief and fiscal space in LDCs	
Box 7.3	135
Malawi: The exchange rate regime and its implications for growth and employment	
Box 11.1	206
Adapting unemployment insurance: Brazil, Chile and Uruguay	
Box 11.2	209
Mexico's fast-response "Preservation of Employment" programme becomes permanent to serve different types of crises	

Contributors

Laurence Ball

Johns Hopkins University

Azita Berar

Director, Employment Policy Department, International Labour Organization

Danilo Fernandes Lima da Silva

Inter-American Development Bank

Davide Furceri

International Monetary Fund

Katja Hujo

United Nations Research Institute for Social Development

Goran Hyden

University of Florida

Iyanatul Islam

Chief, Country Employment Policy Unit, Employment Policy Department, International Labour Organization

Jomo Kwame Sundaram

Assistant Director-General for Economic and Social Development, Food and Agricultural Organization of the United Nations

Donald Lee

Former Chief, Social Perspective on Development Branch, Division for Social Policy and Development, Department of Economic and Social Affairs, United Nations
President, International Committee for October 17 (United Nations international day for the eradication of poverty)

Minquan Liu

Centre for Human and Economic Development Studies, Peking University, and Asian Development Bank Institute

Daniel Leigh

International Monetary Fund

Prakash Loungani

International Monetary Fund

Julian May

Institute for Social Development, University of the Western Cape

Jacqueline Mazza

Inter-American Development Bank

Steven Miller

International Labour Organization

Bettina Prato

Research Coordinator, Office of the Chief Development Strategist, International Fund for Agricultural Development

Marta Roig

Division for Social Policy and Development, Department of Economic and Social Affairs, United Nations

Amson Sibanda

Division for Social Policy and Development, Department of Economic and Social Affairs, United Nations

Introduction

DONALD LEE, MARTA ROIG AND AMSON SIBANDA

The experience of countries that have succeeded in reducing poverty significantly point to the important role of high rates of economic growth combined with high rates of employment growth. High rates of economic growth on their own are insufficient to guarantee that poverty reduction will occur unless the benefits of economic growth are more equitably distributed. The creation of productive employment plays a key role in this regard as a critical nexus between growth and poverty reduction.

However, the challenge of achieving rapid economic growth in combination with high rates of employment generation has become more daunting in the aftermath of the Great Recession and the ongoing debt crisis in the eurozone area. The initial commitment by the leaders of the major economies to avert a deeper recession through coordinated fiscal stimulus packages has been overtaken by an increasing preoccupation with high levels of government debt and a shift towards fiscal austerity. This situation has engendered greater uncertainty about the ability of many troubled countries to achieve more robust economic growth, let alone expand opportunities for productive employment or reduce worsening income inequality. Besides putting jobs recovery at risk in many countries, the effects of the Great Recession and the huge public debt overhang in some advanced economies have also been transmitted to developing countries through channels such as trade, foreign direct investment (FDI) and remittance flows. The marked shift towards fiscal austerity has constrained the policy space available to most countries to prioritize economic recovery through increased government spending and in the process, aggressively tackle the jobless trap faced by the long-term unemployed and young people.

It is against this background that two expert group meetings, on the subjects of poverty and employment, respectively, were organized in collaboration with the International Labour Organization (ILO) in mid-2011, from which the chapters in this collection were drawn. The chapters in this volume are organized into two sections: The chapters in Part I are primarily focused on poverty issues, while the chapters in Part II primarily address employment-related issues.

The first chapter in Part I, by *Jomo Kwame Sundaram*, reviews recent global poverty trends and highlights key issues in the current poverty debate. The author makes the case for a fundamental rethinking of poverty, including how poverty is measured, in order to determine the most useful and effective policy approaches to poverty reduction. Citing the mixed record of poverty reduction efforts around the world, he questions the wisdom of conventional approaches that favour economic liberalization policies accompanied by targeted safety nets and services. The chapter makes the case for a more balanced and inclusive strategy for poverty reduction which has at its core macroeconomic policies focused on achieving stability in real output, incomes and employment. Such a strategy would include universal social policies that address the determinants of asset and income inequality as well as poverty, the implementation of a social protection floor, and the promotion of participation, inclusion and voice of poor people.

The chapter by *Minquan Liu* turns to the process of development and examines the critical role education plays in poverty eradication. The author argues that human capital accumulation, in particular education, is at the core of development not only because it provides a self-sustaining force for development, as experience from East Asia shows, but also because it is considered one of the fundamental goals that development should really be about. He proposes that a long-run strategy to eradicate poverty should focus on education and development, with attention to more immediate priorities in the short term. He believes that such a human capital accumulation-centred development strategy should not be driven entirely by market forces. The chapter goes on to examine the relationship between income inequality, economic growth and poverty, and the respective roles of the State and the market in eradicating poverty. The chapter concludes that the role of the State in the market for education is important in order to ensure full and successful development.

The chapter by *Goran Hyden* explores the relationship between governance, development and poverty eradication in order to uncover lessons learned and new policy considerations. His chapter attempts to avoid a shortcoming of the international policy discourse which tends to equate development with poverty reduction or poverty eradication. The author argues that as our understanding of governance, development and poverty reduction has changed over time, it is also necessary to review the approaches to poverty reduction that are adopted by both donors and recipients. He explores how policies can be made more effective, given these shifts in understanding, by bringing governance to bear on poverty reduction for both donors and recipient countries. The chapter then proceeds to identify the more important lessons learned for understanding and dealing with the governance–development nexus in relation to eradicating or reducing poverty. It ends by discussing new policy options for the future.

The chapter by *Bettina Prato* points to the renewed focus on the role of agricultural development as a driver of inclusive growth and poverty reduction, and the increasing recognition of the potential for agriculture to contribute to food

security and nutrition, and climate change mitigation. However, in spite of this renewed focus on agriculture, there is underinvestment in the sector, and agriculture is becoming increasingly incapable of providing a sufficient, stable income source for poor farming households in the developing world. The author believes that the recent series of global food crises provide important policy lessons about how to better tackle rural poverty. These crises highlight the vulnerability of poor rural people's livelihoods to food price volatility and shocks, as well as the importance of food security and adequate nutrition. The chapter stresses the importance of appropriate policy initiatives that focus on strengthening poor rural people's capabilities as well as facilitating the creation of opportunities. The author argues that poor rural people should not be perceived merely as victims of the price crises but also as active partners who can play an important role in finding a solution to the global imbalances that triggered the crises, by opening up new opportunities for inclusive rural growth and poverty eradication.

Julian May looks at the challenges facing South Africa's efforts to sustain effective anti-poverty programmes beyond the political transformation and economic reforms that have been achieved. Despite being one of the 30 largest economies in the world in terms of gross domestic product (GDP), South Africa is home to the fifth-largest poor population in sub-Saharan Africa. While the author is hopeful that many countries in Africa may see a long-term reduction in structural poverty, he points to two areas of concern. First, there are deep pockets of poverty in many parts of Africa that are not being adequately reached by government policy and which have little chance of benefiting from Africa's wealth or the redistributive policies of its Governments. The second concern is that the economies of many African economies remain inefficient in terms of their ability to translate economic growth into sustained poverty reduction and prosperity for their populations.

Part II turns to the chapters focused on employment-related issues. It starts with the chapter by *Jomo Kwame Sundaram*, which provides a critical overview of the current global employment situation and the way policy choices have shaped the outlook for employment creation and poverty reduction. He argues strongly that, in general, employment policies should be an integral component of a broad, coherent and consistently countercyclical macroeconomic strategy for sustainable development, and points out the crucial role of full and decent employment for the first Millennium Development Goal of reducing poverty by half by 2015. The author reminds us that the policy responses to the Great Recession have done little to address high, if not growing, unemployment in developed countries, and challenges the current preoccupation of policymakers in most advanced countries with reducing fiscal deficits and public debt in the hope of inspiring market confidence. The chapter concludes with a set of policy recommendations to improve macroeconomic and labour market responses to the continuing effects of the Great Recession.

In the next chapter, *Iyanatul Islam* questions the usefulness of the standard

macroeconomic framework and proposes modifications that would make it more development friendly. He points out that much rethinking of the standard macroeconomic framework that emerged in the wake of the global recession of 2008-2009 has been overshadowed by the ascendancy of the fiscal austerity agenda, particularly in the European Union. He notes that developing countries are still preoccupied with fiscal consolidation and inflation control and less focused on poverty reduction, employment creation and social protection. The chapter proposes the adoption of a “dual mandate” in which macroeconomic policy managers act as both guardians of stability and active agents of development. Policies for price stability should be sensitive to country-specific growth-inflation trade-offs, take account of food price inflation and promote financial inclusion. The chapter also argues for fiscal policy that is less focused on attaining predetermined targets for debts and deficits and that aims at restoring growth and employment in times of crisis and at sustainably increasing revenue to meet core development goals.

The joint chapter by *Laurence Ball, Davide Furceri, Daniel Leigh and Prakash Loungani* assesses the short- and medium-term distributional effects of fiscal austerity. Using data for a sample of 17 Organization for Economic Cooperation and Development (OECD) countries over the period 1978-2009, they show that fiscal consolidation episodes have typically led to a significant and long-lasting increase in inequality accompanied by a fall in wage income, without significant effect on profit and rent income. The authors caution Governments to adopt more realistic expectations about the consequences of fiscal consolidation. In particular, they point out that countries should opt for a slower pace of consolidation, combined with policies to support growth. Governments should also take into account how these policies would respond to slower-than-envisaged growth and should be able to adjust them accordingly.

Steven Miller's chapter provides important insights into how Governments should go about achieving full, productive and freely chosen employment for young people. He shows that in the aftermath of the Great Recession, global youth unemployment rose sharply and still has not recovered. The chapter points out that while the private sector is the main driver and source of job creation, it is not creating sufficient decent jobs to meet the requirements of young people entering the labour force, and that there is increased need for direct job creation by public authorities. Such direct public sector interventions are seen as a means of maintaining human capital during financial, civil or political crises or economic downturns, and of supporting the private sector in improving its productivity.

The chapter by *Katja Hujo* examines how labour market and social policies should be financed during and following a period of crisis. The chapter posits that issues of financing and social policy have to be approached simultaneously in order to design social and economic systems that are mutually reinforcing and sustainable. Using concrete country examples, the author presents several instruments available for generating funding for social policies and discusses their

pros and cons, including their impacts on growth and income distribution. The challenge is to ensure that countries with limited fiscal space and high exposure to global market risks are adequately supported at the regional and global levels, especially during times of crises when rich as well as poor countries face similar financing pressures. The chapter notes that the crisis should not result in measures with adverse long-term consequences for State capacity or social development.

Jacqueline Mazza and *Danilo Fernandes Lima da Silva* examine key labour policy experiences of the Latin American and Caribbean region in response to crises, with a particular emphasis on the experience relating to the recent crises. Their chapter notes that the crises did not result in major changes or improvements in labour market policies, probably because many countries in the region were not greatly affected by them. Mexico and other Central American countries that suffered from the crises put in place various temporary measures, including on-the-job training, wage subsidies and temporary employment programmes, and expanded several existing programmes. However, few of these countries put in place more permanent labour market measures, including unemployment insurance, which is available only in some of the richer countries in South America. The chapter concludes that the region's still developing labour market policy mix would be well served to utilize evidence produced during crises more strategically to build long-term institutional capacity and a more permanent set of active and passive labour market policies available both in good and bad times.

The final chapter in Part II of this volume, by *Azita Berar Awad*, takes a critical look at the economic and labour market dimensions of the social and political upheavals in the Middle East and North Africa, commonly called the "Arab Spring". Her chapter points to the failure of economic strategies in the countries in the region to deliver on jobs, particularly decent jobs, which created a widening gap between the educational attainment, capabilities and aspirations of young women and men, and the opportunities available to them. The chapter argues that the post-Arab Spring development agenda needs to focus on the creation of decent jobs. In particular, macroeconomic policies should actively promote employment creation, create fiscal space for investing in labour market policies and human capital, and enhance access to finance for the majority of economic operators. In addition, labour market institutions should actively promote fairness and equal opportunities, reach out to the most vulnerable and provide them options to improve their employability.

Overall, the chapters in this volume emphasize the need to rethink public policy, beyond poverty reduction strategies and labour market programmes, and to reorient macroeconomic policy towards the reduction of poverty and employment creation. They stress the importance of rebalancing the sources of economic growth and taking a more proactive approach to industrial policy and sector-specific strategies. While no single policy prescription can secure the transition to more inclusive, equitable and sustained patterns of economic growth, the chapters discuss economic and social policies that can work together to reduce

20 • The Twin Challenges of Reducing Poverty and Creating Employment

poverty and boost demand in a sustainable manner through increases in decent work and universal social protection, rather than through speculation in credit and asset markets.

PART I

POVERTY ERADICATION

Chapter 1

Poverty matters

JOMO KWAME SUNDARAM¹

Global poverty trends

World leaders agreed in 2000 to halve the number of people living on less than a dollar a day by 2015. There has been some reported success in reducing global poverty levels. The number of people living on less than \$1.25 a day in developing countries is said to have declined from 1.94 billion to 1.20 billion between 1981 and 2010 (figure 1.1). In addition, the proportion of people living in extreme poverty dropped from 52 to 21 per cent over the period 1981-2010. Thus, the Millennium Development Goal of halving poverty by 2015 (MDG 1) is said to have been achieved well in advance of the target year.

Where do the poor live?

The distribution of people living in poverty within and across regions has changed during the past three decades according to World Bank data (figure 1.2). Compared with 1981, the absolute number of people living in poverty in 2005 went up in many countries in sub-Saharan Africa, Latin America, the Middle East and North Africa, as well as Central Asia (see figure 1.2). While 57 per cent of the world's poor lived in East Asia and the Pacific in 1981, the subregion was home to only 21 per cent of the global poor in 2010. In contrast, the share of the world's poor increased in South Asia, from 29 per cent in 1981 to 42 per cent in 2010, and more than doubled in sub-Saharan Africa, from 11 per cent to 34 per cent between 1981 and 2010.

The changing regional distribution of poverty reflects broad changes in

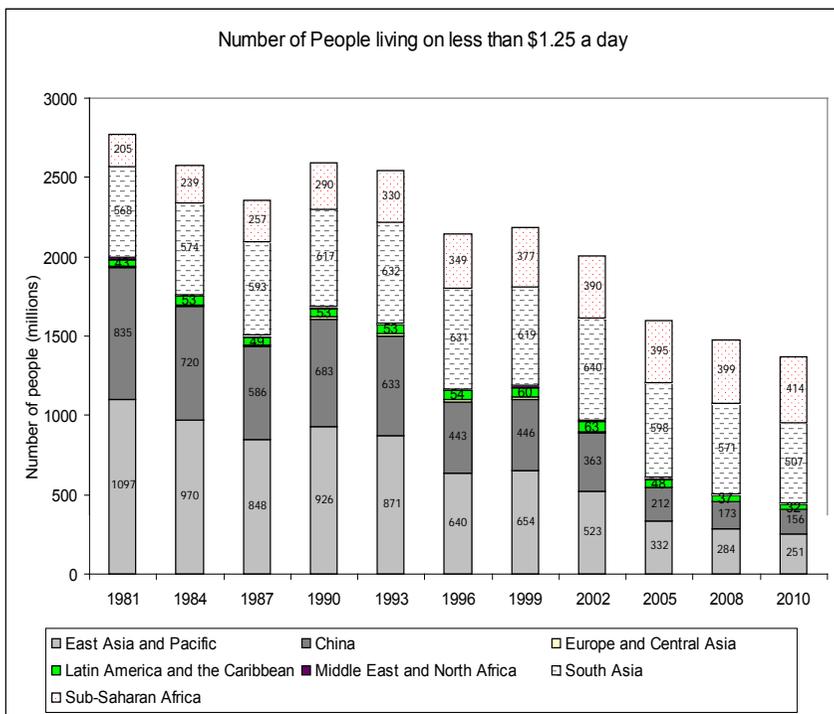
¹ I am indebted to Anis Chowdhury and Amson Sibanda for their assistance in finalizing this introductory chapter. Nevertheless, neither of them are accountable for any remaining mistakes or controversies.

economic performance. The decline in poverty has been largely due to rapid growth in China in recent decades. Most of the world’s poor no longer live in low-income countries (LICs) (Sumner, 2010). In 1990, 93 per cent of the world’s poor lived in LICs. In 2007-2008, 75 per cent of the world’s poor—approximately 1.3 billion—lived in middle-income countries (MICs), while about 25 per cent of the world’s poor, approximately 370 million, lived in the 39 LICs, largely in sub-Saharan Africa.

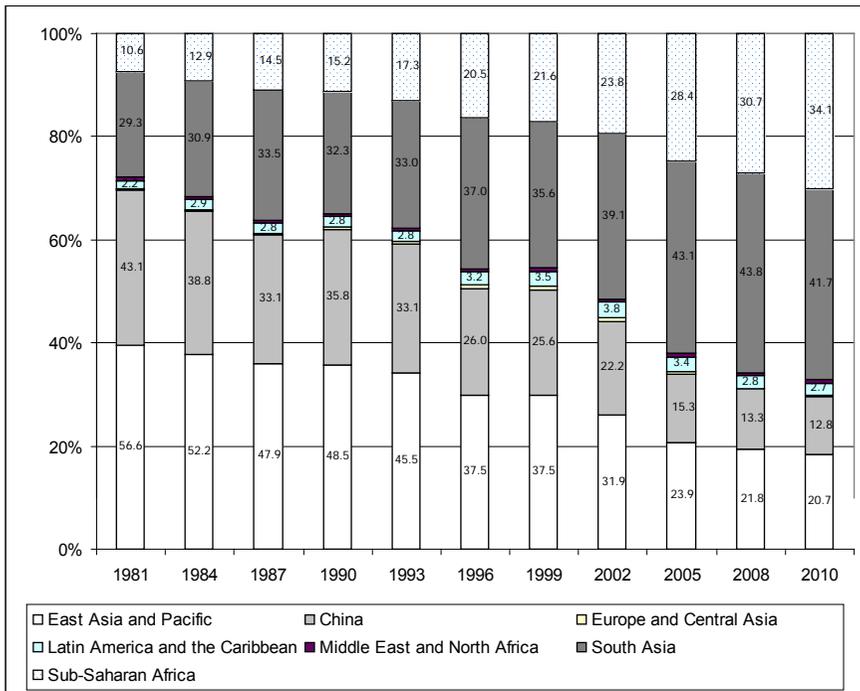
Only four countries (India, Indonesia, Nigeria and Pakistan) account for much of this shift as these MICs are no longer LICs. Besides China and India, the share of global poverty accounted for by other MICs has risen from 7 to 22 per cent. Fragile LICs account for only 12 per cent of the world’s poor, compared with the earlier estimates of approximately 33 per cent. These findings are consistent across monetary, nutritional and multidimensional poverty measures (Sumner, 2010).

Trends in inequality should also be considered, especially by those who view poverty as relative, rather than absolute, in the sense of being defined in terms of a fixed (usually money income) poverty line. Not only are there wider income gaps

Figure 1.1 Global and regional trends in extreme poverty, 1981-2010



Source: World Bank (2013).

Figure 1.2 Changing regional share in extreme poverty, 1981-2010

Source: World Bank (2013).

between rich and poor countries, but within-country income inequalities have also increased in the majority of countries: between the early 1980s and 2008, income inequality rose in 59 out of 114 countries for which data are available, and declined in 40 countries.

Conventional poverty measures

Many analysts have challenged the conventional poverty estimates using the World Bank's \$1.25 a day measure. The main issue is the utility of the poverty line as a meaningful measure of poverty. The evidence suggests that such poverty lines misrepresent the actual extent of poverty. For example, many observers question how poverty has gone down according to World Bank estimates while hunger and undernourishment have increased over the last decade according to the Food and Agriculture Organization of the United Nations (FAO). After all, the poverty line is popularly understood as being defined by the money income required to avoid being hungry.

Reddy (2011) exposes the methodological inadequacies of recent global poverty estimates by the World Bank. The 2008 revision of the World Bank's

global poverty estimates based on a new \$1.25 (2005 purchasing power parity (PPP)) poverty line underscores their unreliability. Furthermore, the new World Bank poverty line does not seem to have considered the United States inflation rate; had it been used, the dollar a day (later \$1.08 a day) line should have become \$1.45 a day in 2005, with obvious implications for corresponding poverty estimates. Reddy argues that the Bank's poverty line is not only flawed, but also not very useful for policy purposes. He argues that much less weight should be given to the Bank's poverty estimates in monitoring MDG 1 to reduce poverty and hunger by half from 1990 to 2015. This has serious implications for international organizations' recent claims to have achieved MDG 1 by 2010.

Chandy and Kharas (2012) emphasize the weak empirical basis for the country and global poverty numbers used by the World Bank. For instance, taking the Bank's figures at face value would imply the following odd facts: the Democratic People's Republic of Korea has roughly the same poverty rate as China. Personal consumption in India has grown at a paltry 1.5 per cent per year since the country's economic takeoff in the early 1990s. In India, with over 900 million cell phone subscribers and 40 million cars, the middle class numbers only 9 million people.

Using these examples, Chandy and Kharas highlight key difficulties in making global poverty estimates. First is the impossibility of saying anything meaningful about poverty in a country without a household survey to explain how income (or consumption) is distributed among its people. The World Bank avoids this problem by making the heroic assumption that any country with no survey has the same poverty rate as the average for its region. Thus, the Democratic People's Republic of Korea is assigned essentially the same poverty rate as China, even though it regularly receives food aid from China.²

Second, surveys need to be reasonably accurate and representative, but the World Bank uses household surveys as an article of faith, even when the data are at odds with other sources of information, which is very common. For example, in the case of India, the survey numbers suggest that the average Indian consumed \$720 per year in 2010, while the country's national income accounts indicate that household expenditure was about two-and-a-half times greater, at \$1,673 per person per year. Such a discrepancy should have dramatic implications for India's poverty estimates—a difference in the order of hundreds of millions.

Uncritical reliance on survey data by the World Bank, therefore, implies that growth in India's household expenditure per capita has been only 1.5 per cent per year since the early 1990s. This also implies hardly any acceleration of per capita household expenditure, as surveys reported an equivalent growth rate of 1.1 per cent during India's pre-reform period. However, corresponding data from the national accounts show that household expenditure per capita grew, on average, by 4.5 per cent annually over the past two decades. Thus, the survey data seem to fail to take account of India's faster economic growth.

The third difficulty is associated with generating global poverty data by

2 China dominates the East Asian regional poverty rate because of its vast population.

using PPP estimates to convert survey data, measured in the local currency, into globally comparable data that take into account cost-of-living differences among countries. Current estimates are drawn from a global exercise conducted in 2005.

In addition to the methodological problems highlighted by Reddy (2011), for some countries, most notably China, PPP conversions have little credibility. China did not permit a random sample of locations to survey prices, as were carried out in other countries. Instead, China restricted data collection to a few urban areas. This resulted in China's prices being 40 per cent higher than previously thought, meaning that Chinese living standards were revised downwards by about 40 per cent.

If one takes this and Chinese growth rates at face value, it would mean that in 1981, China was as poor as the poorest country in the world today (except perhaps the Democratic Republic of the Congo), with a level of average personal consumption below the current level in Liberia. According to the Bank, China has 173 million poor consuming less than \$1.25 a day. But if the PPP conversion rate were changed back to where it used to be, the poverty estimate would be cut to 69 million.

The World Bank's global poverty estimates extend over nearly three decades, with its earliest estimates being for 1981. Throughout this period, the global headcount (based on the 2005 \$1.25 poverty line) has been dominated by three zones/countries: sub-Saharan Africa, China and India. These three account for a remarkably constant three quarters of the world's poor. Yet, poverty estimates for the three suffer from glaring problems, including insufficient survey data, flawed surveys and faulty PPP conversions. If the poverty estimates for these three cannot be believed, then neither can the World Bank's global estimates, and it must be admitted that knowledge of global poverty is very limited.

However, the experience of poverty is increasingly viewed as multidimensional. A wider understanding and definition of poverty, adopted by the 1995 Copenhagen World Summit for Social Development, includes deprivation, social exclusion and lack of participation. Using this broader definition, the situation appears worse than what the monetary income poverty line would suggest. For example, according to the new Multidimensional Poverty Index (MPI) of ten indicators of social development, developed by Alkire and Santos (2010) and used in the *Human Development Report 2010* (United Nations, 2010), there are 1.7 billion poor people.³ Of these, 51 per cent live in South Asia; 28 per cent in sub-Saharan Africa; 15 per cent in East Asia and the Pacific, and 3 per cent in Latin America and the Caribbean. In some countries, the MPI poverty rate is considerably higher than the poverty rate using the money metric of US\$ 1.25 per head.

Besides the ongoing criticisms of poverty measurement, there has been considerable scepticism about reported progress in recent years. The number of poor people in the world in 2008 was reported at 1.29 billion, and the decline in poverty numbers of about 90 million in the period 2008-2010, two years of the

3 The *Human Development Report 2010* considers 104 countries that have data for 78 per cent of the world's population.

Great Recession, as well as higher food prices after 2006 has raised many doubts. Of course, there was a lag in the economic slowdown between the developed economies and developing economies, but more plausible explanations for these trends are needed. With higher unemployment and lower incomes at the end of the last decade, there is concern that PPP calculations may well not capture the higher costs of living for the poor, especially of food, since food dominates the basket of goods constituting the poverty line.

Poverty and vulnerability

Recent economic crises remind us that poverty is not an attribute of a fixed group, but rather a condition that all vulnerable persons risk experiencing. The Asian crisis of 1997-1998 has shown that poverty can go up dramatically within a very short span of time. For example, the poverty rate in Indonesia shot up from about 11 per cent to about 37 per cent following the financial crisis. The financial crises between 1994 and 2002 pushed approximately 40 million to 60 million people into poverty, and possibly as many as 100 million, out of a total of 800 million people (Cline, 2002). An estimated 64 million people fell back into poverty during the Great Recession of 2008-2009 (World Bank, 2010). This is on top of the 130 million to 155 million people pushed into poverty in 2008 owing to soaring food and fuel prices (World Bank, 2009a).

Despite various shortcomings of the World Bank's money measure of poverty, it may serve as a rough guide to assess the extent of vulnerability. For example, the global poverty rate jumps from 18 per cent to roughly 40 per cent when poverty measures are switched from \$1.25 a day to \$2 a day per person, indicating that a large number of people live just above the extreme poverty line (\$1.25 a day) and are probably very vulnerable to economic shocks or changes in personal circumstances.

Vulnerability and economic insecurity have increased during recent decades with the rise in unconventional and precarious jobs such as part-time employment, self-employment, fixed-term work, temporary work, on-call work and home-workers. An important aspect of precarious work is its gendered nature, as women are continuously overrepresented in this type of work. This trend is associated with rapid liberalization and perhaps globalization as well as declining workers' bargaining power.

Procyclical macroeconomic policies in recent decades, focused on achieving and maintaining low single-digit inflation, and limited social protection measures have exacerbated economic insecurity and vulnerability. The *World Social Security Report, 2010-2011* (International Labour Organization, 2011) assumed that people who fall under the international poverty line of \$2 a day have no effective basic social protection and, hence, are vulnerable. The Report assessed the level of vulnerability using two combined variables: the poverty rate, measured

as a proportion of people living on less than \$2 PPP per day within a country, and the extent of informal employment, measured by, as a proxy, the proportion of those who are not employees (in wage/salary employment) in the total number of employed. It found high or very high vulnerability in terms of poverty and labour market informality in 58 countries, corresponding roughly to one third for all countries. By this definition, the majority of the most vulnerable countries are in Africa and Asia.

Social protection and vulnerability

ILO Convention 102 enunciates comprehensive social protection systems covering nine areas.⁴ However, only a small minority of countries currently provide such comprehensive protection. Although all countries in the world provide some form of social security, in many countries, coverage is limited and targeted, rather than universal. Thus, only a small minority of the global population has legal, effective and comprehensive access to existing social protection schemes.

According to the ILO *World Social Security Report, 2010-2011*, only one third of countries globally (with 28 per cent of the global population) have all nine types of social security. Taking into account those who are not economically active, the *Report* estimates that only about 20 per cent of the world's working-age population (and their families) have effective access to comprehensive social protection. This implies that about 5.6 billion people in the world are vulnerable to various degrees.

Working poor

The working poor are defined as those employed, but earning less than \$1.25 PPP a day in 2005. Despite working, they cannot earn enough to get out of poverty. In many developing countries, most poor adults have to work, if only to survive, especially in the absence of adequate social protection. Of the world's poor, 75 per cent live in rural areas where agricultural wage workers suffer the highest incidence of poverty, largely because of seasonal unemployment and the low wages paid by small farms (World Bank, 2009b).

After all, most countries do not provide unemployment insurance or other similar social protection. In the most vulnerable countries, more than 80 per cent of the population have no social security coverage and no access to health services (International Labour Organization, 2011). Women comprise the majority of the working poor: of the 550 million working poor in the world, an estimated 330 million, or 60 per cent, are women (World Bank, 2009b).

There has also been a sharp rise in the working poor due to the ongoing crisis

4 Medical care; sickness benefit; unemployment benefit; old-age benefit; employment injury benefit; family benefit; maternity benefit; invalidity benefit; and survivors' benefit.

in the wake of the 2008–2009 Great Recession. Estimates of the share of workers in extreme poverty suggest that up to an additional 7 per cent, or 215 million workers, were at risk of falling into poverty between 2008 and 2009. Using the \$2 a day poverty line, up to 5.9 per cent, or 185 million workers, were at risk of falling into poverty (International Labour Organization, 2010).

Rethinking poverty

The 2010 United Nations *Report on the World Social Situation: Rethinking Poverty and Poor Poverty: The Impoverishment of Analysis, Measurement and Policies* (Jomo and Chowdhury, 2011) have sought to advance the debate on poverty and its reduction. These two publications reaffirmed the urgent need for a strategic shift away from market fundamentalist thinking, policies and practices of recent decades to more sustainable development- and equity-oriented policies appropriate to national conditions and circumstances.

The two volumes critically examined the conventional policy framework and popular poverty reduction programmes in the face of persisting poverty, rising inequality and lacklustre growth in many developing countries. Current approaches, based on procyclical macroeconomic policies and microeconomic interventions targeted at the poor, are questioned, and a more developmental role for the government is argued. This would entail an integrated approach to economic and social policies to support inclusive output and employment growth as well as to reduce inequality, vulnerability and economic insecurity.

Conventional policy approaches to poverty eradication are insufficient and require serious rethinking by policymakers. The obstacles to reducing global poverty remain formidable, numerous and complex, and have been exacerbated by economic crisis. Countries need to prioritize sustainable development—involving economic development, social progress and environment sustainability—including growth of employment and incomes, with sufficient inclusion benefiting people living in poverty. Targeting is not only expensive, but also inadvertently excludes many of the deserving. Furthermore, many poverty programmes favoured by some donors have not been effective in reducing poverty, although some have undoubtedly helped ameliorate poverty, especially during crises.

Countries, especially in Africa and Latin America, which adopted conventional macroeconomic stabilization measures and structural adjustment programmes generally experienced slower economic growth as well as increased inequality and poverty during the 1980s and 1990s. In general, such macroeconomic policies lowered public investment and increased growth and employment volatility. The mixed record of poverty reduction calls into question the efficacy of conventional approaches. Reductions in public investment in health, education and other social programmes have a disproportionate adverse effect on people living in poverty. They are also more negatively affected by economic volatility, since unskilled

workers tend to lose their jobs first, while job recovery generally lags behind output recovery.

Redefining poverty and its eradication

By most standards, there has been modest progress globally in reducing poverty and deprivation over the last three decades. Other than the spectacular reduction of poverty in China and other parts of East Asia over this period, progress in the rest of the world has been dismal. Wide-ranging deficits in the human condition remain widespread in most LICs, but also in many MICs.

This disappointing situation has persisted despite several growth spurts at the global level and sustained growth in several large developing countries. It has continued despite professed commitments by the global community to the Millennium Declaration. The situation has deteriorated with the ongoing financial and economic crisis. While the timing and sustainability of economic recovery continue to be debated, job recovery and better work conditions will lag considerably behind, with adverse consequences for real incomes and living conditions.

The counter-revolution against development economics (Toye, 1987), enabling the ascendance of the Washington Consensus in the 1980s (Williamson, 1989), significantly transformed the discourse on poverty. Washington Consensus reforms—involving macroeconomic stabilization, defined as low single-digit inflation, as well as microeconomic market liberalization associated with structural adjustment—were all supposed to accelerate poverty reduction. In this new framework, poverty reduction was seen as an almost automatic consequence of economic growth. Little attention has been given to structural causes of poverty, including inequality of opportunities and initial conditions (such as assets), and the distributional consequences of growth. While the reforms were supposed to unleash rapid growth, social policy was reduced to social safety nets for those falling between the cracks as well as victims of temporary setbacks such as natural catastrophes and financial crises.

However, the reforms have slowed growth and exacerbated inequality (United Nations, 2005; Jomo and Baudot, 2007). Washington Consensus policy prescriptions, often imposed through aid conditionalities, have significantly constrained policy space for national development strategies. Failure to sustain growth and reduced government revenues have also reduced developing countries' fiscal space. Such reduction of policy and fiscal space has greatly undermined sustainable and equitable development, with dire consequences for many developing countries.

Developing countries were also expected to reduce the size of their public sectors, significantly reducing State capacity and capabilities. Thus, government capacity was seriously undermined in many countries, which were also being

coerced into liberalizing and globalizing on unequal and debilitating terms.⁵ The World Bank has since emphasized the need for economic policies and policy advice to be more country-specific and institution-sensitive (Nankani, 2005). The 2008-2009 global financial and economic crisis—the worst since the Great Depression of the 1930s—has prompted reconsideration of macroeconomic policies, even within the international financial institutions (see Blanchard and others, 2010).⁶ There is now greater recognition of the need for countercyclical macroeconomic policies and prudent capital account management.

Policy lessons

The decline in influence of the Washington Consensus and the analytical rethinking prompted by the failure to anticipate and redress the ongoing financial and economic crisis has resulted in significant new thinking on poverty and its reduction, as suggested earlier. Some of this recent new thinking on poverty can be summarized as follows:

- The dominant mainstream perspectives on poverty and deprivation have fundamental problems, leading to poor and ineffective policy prescriptions. These policies failed to accelerate growth and reduce poverty significantly, and worse, inequality increased in most countries.
- While growth is usually necessary for poverty reduction, the generation of productive and decent job opportunities is not an inevitable by-product of output growth as the recent pre-crisis record of jobless or job-poor growth implies.
- At the same time, growth needs to be more stable, with a consistently countercyclical macroeconomic stance and better capacity to deal with exogenous shocks. Also crucial for development are measures to promote structural change and reduce inequality (see Stiglitz and others, 2006; Taylor, 2011).

5 Such policy advice and loan conditionalities were challenged by the World Bank–associated Growth Commission (2008), which noted that “... no generic formula exists. Each country has specific characteristics and historical experiences that must be reflected in its growth strategy” (p. 2). It also observed: “In recent decades governments were advised to “stabilize, privatize and liberalize?... this prescription defines the role of government too narrowly. Just because governments are sometimes clumsy and sometimes errant, does not mean they should be written out of the script. On the contrary, as the economy grows and develops, active, pragmatic governments have crucial roles to play” (p. 6).

6 However, after reviewing International Monetary Fund agreements with 41 crisis-affected countries—including Stand-By Arrangements (SBAs), Poverty Reduction and Growth Facilities (PRGFs) and Exogenous Shocks Facilities (ESFs)—Weisbrot and others (2009) concluded that 31 of them contained procyclical macroeconomic policy prescriptions.

- Aid conditionalities as well as treaty commitments have significantly reduced developing countries' policy space. Low growth and loss of revenue owing to economic liberalization programmes have also reduced developing countries' fiscal space. Such narrowing of policy and fiscal space has greatly damaged developing countries, with dire consequences for poverty and destitution (see Jomo and Baudot, 2007; Stiglitz and others, 2006).
- Generally, economies which have done well in terms of both growth and poverty reduction over the past three decades have adopted pragmatic, heterodox economic development policies. While often invoking the language of the market, they have generally managed the market to encourage private investments, especially in desired economic activities, for example, those creating more job opportunities or offering increasing returns to scale.
- Programmes, such as microfinance, formalization of land titles or governance reforms, have not significantly reduced poverty. They have not been effective in the face of faltering growth or in redressing inequality (see Jomo and Chowdhury, 2011).
- Social policies have increasingly involved targeting, ostensibly for greater cost-effectiveness. Generally, however, universal social policies have been much more effective and politically sustainable. Policies targeting the poor, or the “poorest of the poor”, have often been costly, while missing out many of the deserving.
- Social provisioning and protection should be integral to development and poverty reduction strategies. But such redistributive policies cannot be sustained without ensuring rapid growth, thus raising average incomes as well as fiscal resources for social spending.
- Countries that have a social protection floor⁷ can better mitigate the negative impacts of shocks and prevent people from falling deeper into poverty. A basic social protection floor is affordable in most countries, although the low-income and least developed countries will need assistance.

⁷ The right to social security contained in the Universal Declaration of Human Rights requires universal social protection to ensure the basic well-being of all individuals, including people living in poverty and those at risk of becoming poor.

References

- Alkire, Sabina, and Maria Santos (2010). Acute Multidimensional Poverty Index: A New Index for Developing Countries. Oxford Poverty & Human Development Initiative (OHPI) Working Paper No. 38.
- Blanchard, Olivier, Giovanni Dell’Ariccia and Paolo Mauro (2010). Rethinking Macroeconomic Policy. International Monetary Fund Staff Position Note. 12 February.
- Chandy, Laurence, and Homi Kharas (2012). The Contradictions in Global Poverty Numbers: Global Poverty, Millennium Development Goals, Development, Developing Countries, Foreign Aid. Brookings Institution, Washington, D.C. 6 March. Accessed at <http://www.brookings.edu/research/opinions/2012/03/06-contradictions-poverty-numbers-kharas-chandy>
- Chen, Shaohua, and Martin Ravallion (2012). An update to the World Bank’s estimates of consumption poverty in the developing world. Briefing note, Development Research Group, World Bank.
- Cline, William (2002). Financial Crises and Poverty in Emerging Market Economies. Working Paper No. 8, Center for Global Development, Washington, D.C. June.
- Growth Commission (2008). *The Growth Report: Strategies for Sustained Growth and Inclusive Development*. Washington, D.C.: World Bank.
- International Labour Organization (2010). *Global Employment Trends: January 2010*. Geneva: International Labour Office.
- _____ (2011). *World Social Security Report, 2010-2011: Providing coverage in times of crisis and beyond*. Geneva: International Labour Office.
- Jomo, K. Sundaram, and Jacques Baudot (eds.) (2007). *Flat World, Big Gaps: Economic Liberalization, Globalization, Poverty and Inequality*. London: Zed Books.
- Jomo, K. Sundaram, and Anis Chowdhury (eds.) (2011). *Poor Poverty: The Impoverishment of Analysis, Measurement and Policies*. Bloomsbury Academic, London, in association with the United Nations, New York.
- Nankani, Gobind T. (ed.) (2005). *Economic Growth in the 1990s: Learning from a Decade of Reform*. Washington, D.C.: World Bank.
- Reddy, Sanjay (2011). The Emperor’s New Suit: Global Poverty Estimates Reappraised. *Poor Poverty: The Impoverishment of Analysis, Measurement and Policies*, Jomo K. Sundaram and Anis Chowdhury (eds.). Bloomsbury Academic, London, in association with the United Nations, New York.

- Stiglitz, Joseph, Jose Antonio Ocampo, Shari Spiegel, Ricardo French-Davis, Deepak Nayyar (2006). *Stability with Growth: Macroeconomics, Liberalization and Development*. New York: Oxford University Press.
- Sumner, Andy (2010). Global Poverty and the New Bottom Billion: What if Three-quarters of the World's Poor Live in Middle-income Countries? IDS Working Paper No. 349, November, University of Sussex, Brighton: Institute of Development Studies.
- Taylor, Lance (2011). *Growth, Development Policy, Job Creation and Poverty Reduction. Poor Poverty: The Impoverishment of Analysis, Measurement and Policies*, Jomo K. Sundaram and Anis Chowdhury (eds.). Bloomsbury Academic, London, in association with the United Nations, New York.
- Toye, John (1987). *Dilemmas of Development: Reflections on the Counter-Revolution in Development Theory and Policy*. Oxford: Basil Blackwell.
- United Nations (2005). *The Inequality Predicament: Report on the World Social Situation, 2005*. New York: United Nations. Sales No. E.05.IV.5.
- _____ (2010). *Rethinking Poverty: Report on the World Social Situation, 2010*. New York: United Nations. Sales No. E.09.IV.10.
- _____ (2011). *The Global Social Crisis: Report on the World Social Situation, 2011*. New York: United Nations. Sales No. E.10.IV.12.
- United Nations Development Programme (2010). *Human Development Report 2010: The Real Wealth of Nations: Pathways to Human Development*. New York: Palgrave Macmillan for UNDP, New York.
- Weisbrot, Mark, Rebecca Ray, Jake Johnston, Jose Antonio Cordero and Juan Antonio Montecino (2009). *IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-one Borrowing Countries*. Washington, D.C.: Center for Economic Policy Research. October.
- Williamson, John (1989). What Washington Means by Policy Reform. *Latin American Adjustment: How Much Has Happened?*, John Williamson (ed.). Washington, D.C.: Institute for International Economics.
- World Bank (2009a). *Crisis hitting poor hard in developing world*. Press Release. 12 February.
- _____ (2009b). *The global economic crisis: assessing vulnerability with a poverty lens*. WBG Vulnerable Countries Brief. Available from <http://sitere-sources.worldbank.org/NEWS/Resources/WBGVulnerableCountriesBrief.pdf>.
- _____ (2010). *Global Economic Prospects, 2010: Crisis, Finance and Growth* (January). Washington, D.C.
- _____ (2013). *The State of the Poor: Where are the Poor and where are they Poorest?* Washington, D.C.

Chapter 2

Education and the roles of the State and the market in poverty eradication⁸

MINQUAN LIU

Introduction

In examining the respective roles of the State and the market in eradicating poverty, it is first of all important to expand the scope of the enquiry to encompass not only poverty but also income inequality and economic growth. Much of the modern experience of development has shown that, save in a pure Malthusian situation which may sometimes occur but which is generally rare, poverty is closely related to income inequality, and both are closely connected with growth. In attempts to find effective ways to combat poverty, attention must therefore be cast widely enough to examine the effect of income inequality and growth on poverty. In turn, reduction and eradication of poverty can have an important impact on growth and inequality.

This triangular set of relationships among poverty, growth and income inequality has, in fact, received much attention in the literature (see, e.g., Bourguignon, 2004, and Agence Française de Développement and European Development Research Network, 2003), so the basic points need not be further laboured here. Rather, what this chapter intends to do is to push the enquiry a step further by looking at some of the key relationships within this triangle across time, in a manner that would reflect key features of the process of modern economic

8 A draft copy of this paper was presented at the Expert Group Meeting on Poverty Eradication sponsored by United Nations Department of Economic and Social Affairs (UN/DESA) and the International Labour Organization (ILO), 20-22 June, 2011. The author would like to thank the participants of the meeting and Qingjie Xia, Jiantuo Yu and Yimeng Yin for their critical comments. All errors and omissions are, however, the author's responsibility.

development facing a developing country. For much of the poverty which exists in the world today lies, in fact, within these countries, and the persistence of poverty in these countries may in part have to do with certain structural factors they face at present. Understanding such structural factors is important, as it may suggest possible room for effective intervention, as well as limits to such intervention. Within the framework of the poverty–growth–inequality triangle, this also means understanding the process of inequality and, indeed, the process of growth and development itself.

The process of development that is the concern of this chapter involves some rather fundamental changes to the existing social and economic structure of a country. This primarily takes the form of industrialization and urbanization. Early development economists such as Lewis (1954) and Kuznets (1955) studied and provided much insight into this process, as did the literature on poverty traps (Nurkse, 1953; Nelson, 1956). More recently, a growing body of literature has appeared which aims to endogenize occupational choice and inequality (Banerjee and Newman, 1993; Matsuyama, 2000; Mookherjee and Ray, 2005; Galor, 2011). It will not be possible to summarize these bodies of literature, but they offer important insights on which this chapter will draw.

The following section presents a stylized model of what are postulated as the central aspects of the process of economic development which a poor and developing country is expected to go through, and the accompanying challenges it is likely to face as it attempts to successfully manage this process. In this stylized model, as will be seen, fundamental forces exist to cause a Kuznets-type inverse-U relationship to arise between income inequality and per capita income, but the exact trajectory of this relationship need not be completely determined by these forces. Much can be done to change the shape of this trajectory. In terms of poverty, this can mean substantially more or substantially less poverty at any particular point in time during a country's developmental phase. This stylized model will then serve as a framework for discussion in the section that examines the roles of the State and the market in development and poverty reduction. Owing to space limitation, only one market, the market for education, will be discussed.

A stylized model of development

The model

Almost by definition, as an economy embarks on the journey of economic development, it will have to undergo some major structural changes. Specifically, the modern sector (often understood as the industrial sector, although it need not be) will grow, attracting entrepreneurs with the financial capital and workers with the right skills and education to enter into the sector. Almost assuredly, these people will earn a higher income, which is the reason why they moved into this sector

in the first place. On the other hand, the traditional sector (primarily agriculture) may concomitantly be burdened with surplus labour (i.e., labour having low or close-to-zero marginal labour productivity), and frequently with high birth rates as well. This is the setting Lewis (1954) was concerned with in his pioneering contribution to the subject.

The presence of a possibly large income differential in favour of a relatively small section of the population (those in the modern sector) in the early stage of development is highly likely to worsen income inequality in that economy. Over time, however, such differentials are likely to attract an increasing number of people to enter into the modern sector, through acquisition of appropriate skills and education. As more and more people move into this sector, the incomes accruing from it will be spread more widely. At the same time, earnings in the agricultural sector will also likely improve (not only might labour productivity rise as a result of applications of modern science and technology to farming, but so would demand for farm produce). And with generally better education and health services for the agricultural sector as well, birth rates may fall in rural as well as urban areas, reducing the rate of growth of the labour force. Eventually, a point will be reached when income distribution improves. This is essentially the reason which led Kuznets (1955) to advance the now well-known inverse-U hypothesis between income inequality and economic growth.

But it may be worth exploring in more detail how all this might happen. What the stylized model to be developed below does is to focus on the crucial role which human capital accumulation plays in the process.⁹ Needless to say, financial capital is important, and some models in the endogenous inequality literature have indeed focused on that, where imperfect capital markets result in some (the rich) being able to borrow funds to invest in worthwhile projects and receive handsome returns on them, and others (the poor) not (Matsuyama, 2000). The distribution of financial assets is, of course, an important consideration that could have serious implications for the course and character of development. But, over the very long run considered here, it could be argued that even the rich must have, in most cases, owed their wealth to human capital accumulations by themselves or their ancestors.¹⁰

Thus the stylized model below shall focus on human capital accumulation only. At the level of an individual, human capital accumulation (principally education, but also health) raises his or her productivity and, hence, income. From the point of view of an economy, such accumulation (in the form of increasingly better and more widespread education for the population) raises aggregate

9 This stylized model was first presented in Liu and Yin (2010) as a framework for understanding the long-run factors that characterize and explain the economic successes of some East Asian economies in the past few decades.

10 Various predatory forms of wealth-amassing may also have been a cause, but even in those cases, as classical economists would remind us, labour is, after all, the sole source of all wealth.

productivity and thereby aggregate income.¹¹ To examine the simplest possible case for this, only two categories of workers, skilled and unskilled, are assumed, who work in a skilled and an unskilled sector, respectively. What differentiates one from the other is education. An unskilled labourer could be anyone from a traditional agricultural worker to someone working in the modern sector but doing menial tasks or otherwise engaged in providing some low value added services, often with little education. On the other hand, to be a skilled worker one has to undertake comparatively more—sometimes a lot more—education, involving considerable human capital investment. Note that this categorization of skilled and unskilled worker cannot but be left somewhat vague. In the early phases of development, an unskilled (in most cases, rural) labourer may well be illiterate. Subsequently, basic education may become popularized, so that even an unskilled worker may have to have some basic education. Similarly, it might have required someone to acquire only a basic education by today's standards to be a skilled worker in the early phases of development, but subsequently it would require a person to receive a lot more education—often tertiary—in order to qualify as a skilled worker. These changes are but part of a worldwide trend towards increasingly better and more widespread education in a society which has happened in most countries from developed to developing over the last century.¹²

Figure 2.1 provides the basic elements for the model, where the supply curve of the unskilled labour is S_A , and that of skilled labour S_I . The shape of these curves, each involving a flat and an upward sloping segment, needs some explanation. First, earlier literature on development (Lewis, 1954; Sen, 1966) stressed the importance of rural surplus labour, meaning labour that produces a zero or close-to-zero agricultural marginal product. If such surplus labour indeed exists, then it could be argued that the opportunity cost of unskilled labour is simply its agricultural marginal product. This implies a zero or close-to-zero reservation wage rate. However, the opportunity cost is only one way to think about the reservation wage. There is also the factor of the “subjective cost of labour”, which is a person's marginal disutility of labour (or marginal utility of foregone leisure) weighted by his marginal utility of income. Typically, this would give a positive value, and hence a positive reservation wage rate. Sometimes, though,

11 Additionally, it can raise the share of income accruing to labour, which should be good for income distribution, as we shall see later in this chapter.

12 It is worth emphasizing that the basic dichotomy of skilled and unskilled workers is used here only as a simplifying device, to enable us to better develop a sense of what is involved. The underlying issues have also been modelled as a case of “occupational choice” in the new literature on endogenous inequality, where the occupational choice space can be dichotomous, a multitude, or even a continuum. See Mookherjee and Ray (2005, 2010) and the references therein. Our dichotomous characterization leaves out the important role of entrepreneurs. See Banerjee and Newman (1993) for a model of how the otherwise identical agents may differentiate into entrepreneurs and workers because of capital market imperfections, according to the initial distribution of wealth.

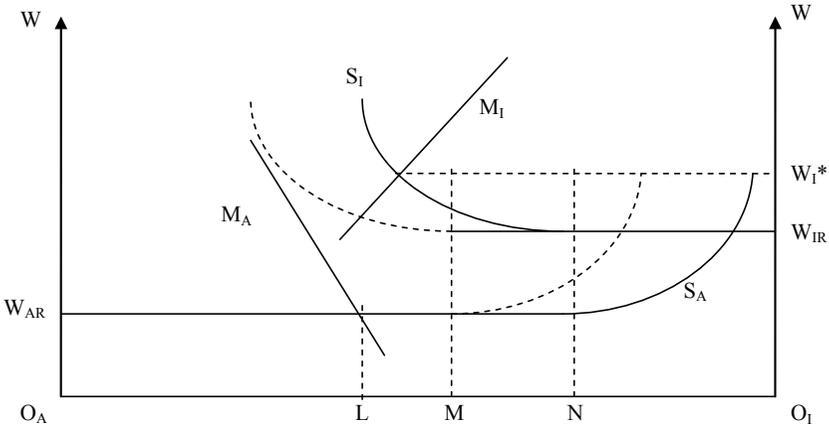
where survival is at stake, the subjective cost of labour, although positive, may fall to a very low level indeed (as marginal utility of income in this case sharply rises vis-à-vis that of leisure—nothing is more important than survival here and now, so to speak, not even the sheer drudgery of the labour involved). In these cases, the subjective cost of labour for a person may well fall below the minimum cost of living that would be necessary to ensure a person's continued survival and continued supply of labour (i.e., to ensure that he could make the same level of physical and mental exertion indefinitely into the foreseeable future). It is this latter cost, denoted by W_{AR} in figure 2.1, which will be used as the reservation wage for unskilled labour in the present model.¹³

Second, regarding the reservation wage for the skilled, let a premium reflecting the cost of past human capital investment be added on top of the unskilled reservation wage. This, of course, necessitates the assumption of a perfect capital market whereby persons can borrow against future incomes to invest in education today. However, much of the economic literature has, in fact, concluded that capital markets are seriously imperfect, especially in developing countries. In the present model, allowing for imperfections of the capital market would mean either that some unskilled workers are denied the opportunity to make the necessary investment in education to land them in the skilled category, or, even if such opportunities are not completely denied, that they carry a higher cost, implying a higher necessary wage markup than if the capital market were perfect, to derive the reservation wage for the skilled. These complications shall, however, be ignored in this chapter. When the respective roles of the market and the State in eradicating poverty are discussed in the following section, these issues will also be taken up. In the present stylized model, the uniform, post-markup reservation wage is W_{IR} .

Third, since the focus is on human capital accumulation in an economy, the horizontal axis in figure 2.1 is used to denote the number of workers in both the skilled and unskilled categories. Levels of skilled and unskilled wages can, of course, affect the supply of labour hours by workers in each sector, but they would not influence the numbers of workers working in these sectors, which are solely determined by past education. However, with assumptions of social and cultural (or indeed legal) norms on a standard number of hours to be worked by a worker over a given natural time period (a day or week), the extra hours supplied by workers in each sector in response to a higher wage may be converted into an equivalent additional number of workers working in these sectors. As may be expected, the higher the wages for a sector, the greater the number of hours

13 That is, under WAR, a labourer may continue to deliver the same amount of labour per day or month indefinitely into the foreseeable future. A person may, of course, depend on his or her family for survival and continued function as a labour supplier, but the family's survival will in turn have to depend on the incomes earned by its members. For a critique of the concept of “subsistence wage”, see Dasgupta (1997).

Figure 2.1: A two-sector long run model of labour markets for skilled and unskilled labour



Source: Author’s own elaboration.

supplied to it, and the greater the equivalent number of workers working in that sector.¹⁴

The above explanations together then imply the shape of the two labour supply curves as drawn in figure 2.1. The horizontal distance between O_A and O_I , two origins of the graph, indicates the size of the full labour force. Initially, the $O_A N$ portion of the entire workforce is unskilled, and the rest is skilled. Between O_A and N , the S_A curve is flat (any demand less than $O_A N$ will not push the unskilled wage rate above W_{AR}), while beyond N the curve slopes upwards (any demand beyond it will raise the unskilled wage rate above W_{AR}). A parallel reasoning lies behind the shape of the S_I curve.

While supply-side factors in the stylized model essentially concern the long run, demand-side ones are primarily about the short run. In figure 2.1, demand for unskilled labour is given by the M_A curve, and for skilled labour, the M_I curve. They are given by the marginal revenue product of labour curves in the two sectors, which are in turn conditional on technology and product market prices for firms in these sectors. Although technology is not expected to change materially in the short run, product market conditions and prices may well do so. Both may give short-run shocks to the system. And when they do, the two labour demand curves shift.

The model thus captures both long-run and short-run factors, and there are

¹⁴ There is the complication of overtime pay, which in developed countries could be a significant markup on a standard wage. Although overtime pay may also have been made into law in some developing countries, its enforcement has usually been a problem.

also long-run and short-run outcomes to consider. In equilibrium, the markets for hours of labour must clear in both sectors, giving rise to equilibrium wages for these sectors. However, while in the short run, the hours supplied may equal the hours demanded, this need not mean that, in the long run, all those who are dedicated to the skilled or the unskilled sectors in terms of human capital are necessarily fully taken up by these sectors (i.e., there need not be full employment). Figure 2.1 depicts such a situation in the unskilled sector, where the demand curve gives rise to the short-run equilibrium wage equal to the reservation wage. However, a significant number of unskilled workers (equal to the distance between points L and N) are unemployed. On the other hand, the skilled sector shows full employment. It transpires that, in both sectors, any equilibrium wages that are above their respective reservation wages must mean full employment. However, if they are only just equal to the reservation wages, some level of unemployment in the workforce may well prevail in the sector in question.¹⁵

The stylized model presented in figure 2.1 provides a useful framework for analysing a number of important points about the process of economic development.

Education and “demands of full development”

What is meant by “full development” is a situation where no person is directly left out of the process and fruits of development.¹⁶ Specifically, this means that the process of shifting workers from the unskilled to the skilled sector, which according to the view of this chapter is the essence of development, must eventually encompass everyone in a society. This need not mean that everyone must eventually become skilled and do only skilled work. Even in an ideal situation, some may remain unskilled for various reasons, but all those who want to become skilled should have the opportunity to do so (this is the “process” part of the demands of full development). Moreover, even those who are not skilled can also enjoy the benefits of development. Specifically, they should enjoy more or less the same standards of well-being, which in the present model means more or less the same wages (this is the “fruits” part of the demands of full development).¹⁷

15 Given these interpretations, naturally, equilibrium labour supply points of the two sectors need not be vertically aligned in the present model, with or without full employment in either sector.

16 Indirectly, of course, no one can really be left out of any development process unfolding in his or her country or community.

17 Note that our view of what development centrally involves, by and large, conforms well to the human development perspective, which argues that the aim of development is to enlarge people’s capabilities to live the lives they value, where the basic capabilities are health, education and a decent standard of living. Indeed, the view of development presented here may be considered a reduced version of that, focusing as it does even more centrally on education. Naturally, health is important and may even be considered to have priority over education, as everyone must first be alive and healthy before they can

The key to full development in the present model clearly rests with the expansion of education—indeed, a full expansion of superior education opportunities to everyone. How this may be achieved (whether through a complete reliance on the market, or whether the State, in fact, has a role to play) will be discussed in the following section. For now, let us briefly note two other important effects of education (i.e., other than turning an unskilled worker into a skilled one). First, past experiences from regions like East Asia suggest that a well-educated workforce may well increase the demand for skilled workers as well. Indeed, part of the reason why some East Asian economies have enjoyed spectacular economic successes in the past several decades may have been exactly to do with this, giving rise to a beneficial cycle of events. This theme will be taken up again later in the chapter. Second, vast amounts of research also indicate that education, especially female education, has an important downward impact on fertility, and an upward impact on the quality of childhood upbringing. Both these impacts should have a clear effect on the present model, but will not be explored here.

Inequality and “demands of successful development”

The model turns out, in fact, also to provide a way of capturing the Kuznets-type inverse-U relationship between income inequality and economic growth. If one imagines that, at the beginning of the development process, all workers are unskilled and earn an unskilled wage (which is most likely to be the reservation wage) and that at the end of it, all become skilled workers and earn a skilled wage, then over the process, when an increasing number of workers must move from the unskilled to the skilled sector through education, income inequality must first rise and then fall. Thus, if one accepts the characterization of the essence of a full development process as embodied in the model, then the Kuznets hypothesis is clearly right. The key point here is full development. Not all development processes may, however, be full. Some may become stuck along the way, with persistently high levels of inequality. It is not clear whether these economies are merely going through a difficult phase and will soon see the light at the end of the tunnel, or whether they may indeed be stuck indefinitely. One thing is clear, if they are going to come out of the process fully, their income inequality will come down.

The above discussion may sound tautological: full development must be characterized by low income inequality at the end of process, and if an economy goes through the process fully, it must show a low level of income inequality. But it is not. For the key to bringing about full development as identified in the present model is human capital accumulation. When all people in an economy are well educated and skilled, there should be no reason why income inequality must effectively pursue education. For reasons of space limitation, issues of health cannot be addressed here. Note that in addition to its instrumental role in the economy, education also has intrinsic value for many, as the human development view well emphasizes. See Sen (1999).

stay high. Indeed, according to available wage share statistics, in most developed countries where education is more widespread, equal and of higher quality, wage incomes typically account for around 70 per cent of all incomes (although the share has fallen in recent years, for reasons which cannot be delved into here). In other, less developed countries, the share typically tends to be much lower. On average, it is, in fact, in these less developed countries that better records of income distribution are to be found (Schneider, 2011; Stockhammer, 2013).

While the present model demonstrates that a Kuznets-type inverse-U trajectory of income inequality vis-à-vis per capita income may indeed arise if and when the development process is fully completed (eventually all workers will enjoy good and equal educational opportunities), the exact shape of this trajectory is yet to be determined. Much, in fact, will depend on how various factors play out over the course of development. And this opens up ample scope for policy intervention, both in the short and long run. A closer examination of the model suggests that, within the terms of the model, the gap between the skilled and unskilled wage rates can influence the concavity of the inverse-U curve. Specifically, the greater the wage gap over the course, the more concave the curve (and the higher the peak of the curve). Thus, besides aiming eventually to give everyone an equal and good opportunity to education (which is what “demands of full development” are about), a Government, if it also wishes to manage development successfully, must also aim judiciously to keep the wage gap at low levels—indeed as low as possible without compromising the incentives for agents to invest in education. These requirements may be called “demands of successful development”.

Poverty

What about poverty? Poverty is not immediately visible from the present model. Indeed, whether in respect of absolute poverty or relative poverty, poverty cannot but be defined and measured in reference to some poverty-line level of income. Unless and until this line is specified, poverty remains undefined. Where might one find poverty in the present model? The poverty line income could be defined to be just above the unskilled reservation wage rate (but definitely below the skilled reservation wage), in which case all those earning that wage (and this is likely to include everyone in the unskilled sector) are poor. Development in this case is tantamount to a process of poverty reduction. This, however, would appear to be too broad a definition of poverty.¹⁸ Rather, one may define it to include only

18 While development must, among its aims, tackle poverty, to limit the aim of development entirely to poverty elimination would appear to be too modest an ambition, and in any case would not seem to accord well with the general sense in which we understand poverty. Note that we have earlier defined the unskilled reservation wage to be equal to the minimum cost of living that would be necessary to ensure a person’s continued survival and continued capacity as a labourer. This could be seen as in line with a threshold level of income for absolute poverty. Thus, while only making the unemployed the poor in our model, one should not forget the fact that even those employed unskilled

those who are unemployed, in principle from both sectors but primarily or even exclusively from the unskilled sector.¹⁹

In figure 2.1, an LN number of unskilled workers are unemployed and live in poverty. There are short-term measures to combat this: anything that could increase job opportunities in this sector (that is, anything that can push out the unskilled labour demand curve) can reduce poverty. However, over the long run, the best approach to combating poverty is to invest in education, to move those who could otherwise end up unskilled (or who could otherwise stay unskilled) to the skilled category. Other things being equal, the more this happens, the less unemployment there can be from the unskilled sector, and the less poverty overall.

And in considering a long-term approach to combating poverty that is based on education, short-term measures intended to push out the two demand curves for skilled and unskilled labour can be seen to make a contribution to long-run reductions in poverty as well. In the former case, a rise in the skilled equilibrium wage can increase incentives for private investment in education; in the latter, an increase in the unskilled equilibrium wage can increase private resources available for such investment.

The roles of the State and market in development and poverty eradication

The market, the State and the vision

The stylized model presented above postulates that development is essentially about human capital accumulation. In addition, it is argued that full development demands that all people in a society eventually enjoy the same opportunities of superior education, and that successful development ought to mean that development be managed in such a way that income inequalities are kept as low as possible without compromising people's incentives to invest in education. In the long run, poverty is to be eradicated as part and parcel of this development process. This constitutes, as it were, the long-run goals of development. That being so, the resulting strategy for development must centre on human capital accumulation. This section discusses how such a strategy might work in respect

workers are in fact just above poverty, and could easily fall back into it should there be any shock to the economy (any leftward shift in the unskilled demand curve in our model).

19 While unemployment can in principle happen to skilled workers in our model as well, as a rule it will be assumed not to (certainly not that of the long-term, structural kind). To allow this to occur would be against the very spirit of the development process postulated here. Short-term, frictional skilled unemployment may well occur, but in these cases one may expect the temporarily unemployed to live on their savings and to stay out of poverty.

of one market, the market for education, and the respective roles of the market and the State therein.

The economic literature—and the social science literature more generally—contain countless discussions of both market and State failures. Textbooks routinely offer quite stringent criteria for a perfectly competitive market. Failure to meet any of these is said to result in a market failure. In practice, few markets, if any, satisfy these criteria. And where there is a market failure, the Government concerned may be advised to take any one of the following courses of action: do nothing (*laissez faire*); regulate and improve the functioning of the market in question (market strengthening); form partnerships with the market (public and private partnerships, or PPPs), or directly take over all or some of the functions of the market (market substituting). Active public policy may involve all or any of the latter three courses of action, but exactly which would be the most effective one to pursue in terms of best improving on the existing allocations by the market, yet in a cost-effective manner, is case-specific. Solutions that may improve on an existing market allocation but which are highly costly are unlikely to be selected, and rightly so. And it has also been widely recognized that, sometimes, a policy package with a set of coordinated and complementary measures to address failures in a range of related markets may be more effective than a single-pronged attack on any one of these failures.

But if these are the only ways to think about the role of the Government and how it may intervene in a market, something fundamental is missing. There must also be vision, leadership and strategic planning from the Government. In contrast to the function of detailed allocations which a market may or may not perform well given circumstances (market conditions), vision, leadership and strategic planning are things which a market simply cannot provide.

This may sound like calling for a return to the days of central planning and State socialism, but to see it that way would be a mistake. First, some government planning, yes; but State socialism, no. Second, even when it comes to planning, it has to be based on a vision that all shall eventually receive an equal chance of good education, which would appear to be both far better ethically grounded and far less ambitious than the vision (if there was one) that guided past central planning under State socialism (where people were supposed to live the lives that were planned for them).

The case for vision, planning and leadership is paramount. Market fundamentalists may view all this as gibberish. In their mind, why should a Government have a vision anyway? Why shouldn't one leave things to the market, and accept whatever it delivers, for it may well be the best outcome possible? However, to accept this view would be tantamount to condemning the vast number of the poor to perpetual poverty, for history has shown that markets alone, with their inevitable failures, simply cannot rid a country of poverty. If they could, they would have done so already! And ad hoc interventions in the normal

functioning of the market cannot deliver the full and successful development which this chapter postulates either, for reasons just explained.

The market for education

Under a human capital accumulation-centred development strategy, the first most important area of policy concern, or what should constitute the centrepiece of policy under this strategy, must concern investment in education. Such investment may be organized through the market, and in many parts of the world and to varying extents, this has indeed been the case. In theory, if the capital market is perfect, if there are perfect foresights on future returns to education, and if there is also no externality involved in education, individuals should make both privately and socially optimal investment decisions. However, as has been well recognized, externality in education does exist, and perfect foresights on future returns to education are simply not possible. So even privately optimal decisions made by (risk averse) individuals may not be socially optimal. Further, the capital markets may be seriously imperfect, especially in developing countries, such that even with good human capital investment opportunities, individuals may not be able to borrow against their future streams of income, unless they have adequate resources to offer the required collateral. This means that poor individuals or families may, in the end, not be able to take advantage of such opportunities. But they are from the viewpoint of this chapter precisely the people whom development must aim to encompass.

Given its key role and strategic importance in moving development forward, there is clearly a case here for active public policy in respect of education (doing nothing is simply not an option). Nothing is more important than an adequate, sustained level of investment in education if one wants eventually to pull a country out of poverty and underdevelopment. Such actions may take the form of any, or indeed all, of the three active courses of public action noted above. Thus, efforts may be made to improve the working of the capital market when it comes to, for example, offering student loans. Private and public resources may be combined to make investments on the supply side to increase and improve educational facilities (schools, colleges, universities) and the quality of teaching, and on the demand side to provide scholarships, hardship allowances and other similar schemes to enable students from poorer families to avail themselves of the opportunity. Stand-alone direct public investments may also be made to supplement suboptimal private investments on both the demand and supply sides. To ensure that such investments do not crowd out private investments, public investments may be used to target areas of education where private investment is particularly lacking, or those that need specific promotion for reasons of externality and, indeed, equity. One such case is universalizing basic education. In many developing countries, while some sections of the population are already enjoying fairly high levels of education, others are still left without even basic education. Receiving a basic education would be especially important for these people if they are to be part

of the development process. With general improvements in educational levels across the world and, hopefully, in the country concerned, even though such basic education may not be enough to turn a person into a skilled worker, it may be a necessary qualification for that individual to become an unskilled worker in the future (as without this basic education, he or she may even become completely unemployable). Ultimately, of course, full development should ensure all people an equal chance of receiving the education available.

But, as already argued above, the role of the State should not be limited to making only such ad hoc interventions in the otherwise normal functioning of the market (where the market is in the driver's seat, so to speak). The role of the State must, especially in this crucial area of development, include a vision, leadership and strategic planning. Beyond this general call for the State to act in matters of education, there is another immediate practical imperative: it will take years to educate a skilled worker, and it is better to do so while he or she is still at the school- or college-attending age. Therefore, some forward planning must be done if future demands for skilled workers are to be appropriately met.

But vision and planning should not be limited to making sure that only future needs for skilled workers are to be properly met. After all, where are the clear signals on such future needs to come from? Vision, planning and leadership must also be about shaping expectations and making things happen! Doing so is not about entertaining far-fetched ideas; it is about being at once realistic and farsighted. On matters of education, there is, in fact, the East Asian experience to guide us.²⁰

Consider the potential beneficial loop noted above about education (seen against the numerous vicious cycles that usually lurk along the treacherous path of development, this surely is one of the few beneficial ones to be quickly seized upon). It will not only supply a steady stream of skilled workers, but may also promote demand for these workers. This can especially be true today with mostly externally open economies, free trade regimes, and increased levels of international trade and foreign direct investment. With a well-educated and skilled workforce, a country can produce and provide high-quality and knowledge-intensive goods and services not only for its own domestic market, but for the international market as well. The demand for these goods and services can therefore be rather elastic or even shift, and accordingly the demand curve for skilled labour may also shift. Moreover, the presence of a strong workforce of skilled workers may also attract international demand for reasons of reputation, industrial clustering and agglomeration effects, the ripples of which may spread across the globe. In short, increased supplies of skilled workers, thanks to education, may actually create their own demands for these workers. This is a modern example of Say's law,²¹ and is the first part of the East Asian success story.

20 For experience of some East Asian countries in this and other areas, see Liu and Yin (2010) and the references therein.

21 Say's Law states that supply creates its own demand.

But might the education market in fact rise to meet the challenge of its own accord, without any government involvement? The most informed answer is that, left to its own devices, the market will not. A key factor causing critical failures in this market is the lack of good foresight about the future by private agents. The reason has to do with expectations. Needless to say, no expectation can ever be perfect in the sense of eliminating all uncertainties. But a greater availability of credible signals from the Government regarding its vision, its specific plans and aims, and indeed a stance of strong leadership and commitment, can help private agents to make better and more intelligent decisions about education for both themselves and their children, especially when it comes to having these households borrow for such education, often against their limited present wealth or future streams of income. On the lenders' side, such vision, commitment and leadership from the Government should also help them to make better and more intelligent decisions about lending.

Therefore, a clear vision from the Government with strong leadership and strategic planning in matters of education can even help the market function better. But it would be unrealistic to think that the State needs to provide only vision, planning and leadership. Even with a greater clarity of direction and purpose from the Government, it will be extremely unlikely that the market can, then, do all the delivery work alone. There is therefore a case for the Government also to roll up its sleeves and do the hard work of delivery itself, in a way that complements the private market. As noted, this could involve direct government investment on both the demand and the supply sides. The Government could even form partnerships with the private sector in certain programmes. And, of course, it must regulate the private sector by monitoring the quality and standards of teaching, and strengthening the capital market as much as possible. This is the second part of the East Asian success story.

In addition to the experiences from East Asia, more recently, some successful cases of public policy intervention that target education have emerged from other parts of the world. Thus, cash transfer programmes such as Brazil's Bolsa Familia programme have been tried in several Latin American countries. These tie social relief to a household to investment in its children's education, in the form of education-conditioned cash transfers. Certainly, the education so targeted is only basic. However, as one step in an attack on the lack of even basic education among the poor, it has much to recommend itself, even though further study is necessary on issues about the quality of education received and the necessary additional measures to make it part of an overall approach to attacking the problem of education in these countries.

Conclusion

This chapter postulates that the essence of development rests with human capital accumulation, in particular education, both because education can provide a self-sustaining force for development, as experience from East Asia shows, and because it is essentially one of the few things which development should really be about. Poverty, in the long run, is to be tackled through education and development, although an anti-poverty programme may have more immediate priorities in the short term. However, a human capital accumulation-centred development strategy cannot entirely rely on the market. The State must have vision, leadership and strategic planning, as well as make other substantive interventions in the normal functioning of the market. Following a discussion, in particular, of the case of the market for education, the chapter finds ample room for State action if the long-run aim of full and successful development is to be realized.

References

- Agence Française de Développement and European Development Research Network (2003). Poverty, inequality and growth. Proceedings of the French Development Agency-European Development Research Network Conference, Paris.
- Banerjee, Abhijit V., and Andrew F. Newman (1993). Occupational choice and the process of development. *Journal of Political Economy* (Chicago), vol. 101, No. 2, pp. 274-298.
- Bourguignon, Francois (2004). The poverty-growth-inequality triangle. Paper presented at the Indian Council for Research on International Economic Relations, New Delhi. 4 February.
- Dasgupta, Partha (1997). Nutritional status, the capacity for work, and poverty traps. *Journal of Econometrics*, No. 77, pp. 5-37.
- Galor, Oded. 2011. Inequality, Human Capital Formation and the Process of Development. NBER Working Paper No. 17058. Issued in May 2011
- Kuznets, Simon (1955). Economic growth and income inequality. *American Economic Review*, vol. 45, No. 1, pp. 1-28.
- Lewis, W. Arthur (1954). Economic development with unlimited supplies of labour. *Manchester School of Economic and Social Studies*, vol. 22, pp. 139-191.
- Liu, Minquan, and Yimeng Yin (2010). Human development in East and South-east Asian economies: 1990-2010, Human Development Research Paper, 2010/17, United Nations Development Programme. Available from http://hdr.undp.org/en/reports/global/hdr2010/papers/HDRP_2010_17.pdf (accessed 15 May 2012).
- Matsuyama, Kiminori (2000). Endogenous inequality. *Review of Economic Studies*, vol. 67, No. 4, pp. 743-759.
- Mookherjee, Dilip, and Debraj Ray (2005). Occupational diversity and endogenous inequality. New York University and Instituto de Análisis Económico (CSIC). 23 June. Mimeo graph.
- _____(2010). Inequality and markets: some implications of occupational diversity. *American Economic Journal: Microeconomics*, vol. 2, No. 4, pp. 38-76. Available from <http://www.aeaweb.org/articles.php?doi=10.1257/mic.2.4.38> (accessed 15 May 2012).
- Nelson, Richard R. (1956). A theory of the low level equilibrium trap in underdeveloped economies. *American Economic Review*, vol. 46, No. 5, pp. 894-908.
- Nurkse, Ragnar (1953). *Problems of Capital Formation in Underdeveloped Countries*. Oxford: Basil Blackwell.

- Schneider, Dorothee (2011). The labor share: a review of theory and evidence. SFB 649 Discussion Paper 2011-069, Humboldt University, Collaborative Research Center 649.
- Sen, Amartya (1966). Peasants and dualism with and without surplus labour. *Journal of Political Economy*, vol. 74, No. 5, pp. 425-450.
- _____ (1999). *Development as Freedom*. Oxford: Oxford University Press.
- Stockhammer, Engelbert (2013). Why have wages fallen? A panel analysis of the determinants of functional income distribution. *Conditions of Work and Employment Series No. 35*. Geneva: International Labour Office.

Chapter 3

Governance, development and poverty eradication

GORAN HYDEN

Introduction

For over a decade now, the international policy discourse has been premised on the thesis that development equals poverty reduction or poverty eradication. This is particularly strongly stated in the United Nations Millennium Development Goals (MDGs) which target improvement in human welfare and the human condition. While approaching the finish line for this bold international project to tackle poverty on a global scale, it has also become clear that (a) development is more complex than just poverty reduction, (b) poverty reduction itself is a contested practice, and (c) governance, as the critical process variable in this context, has differential impact depending on the socioeconomic, that is, developmental conditions of particular countries.

This chapter tries to unpack the relations between governance, development and poverty eradication in ways that point both to lessons learned and to new policy considerations. It begins by showing how the understanding of the key concepts discussed in this chapter have shifted in the past decade and thus laid the ground for changes also in policy. The next section discusses the challenges of bringing governance to bear on poverty reduction, drawing attention to issues in donor circles as well as recipient country contexts. The chapter then proceeds to identify the more important lessons learned for understanding and dealing with the governance–development nexus in relation to eradicating or reducing poverty. It ends by discussing new policy options for the future.

Shifts in understanding

Beginning with *governance*, there has been a considerable change in how the international policy community understands the concept and translates it into specific assessments and practices. Ten years ago the idea was that governance is a prerequisite for development; it translates into the application of a liberal democratic model; and, it relies on elaborate comparative measurement methods to

indicate where on a global ladder of “good governance” particular countries stand. The “mother” of all these score-carding indices was the Worldwide Governance Indicators produced by the World Bank Institute (for example, Kaufmann and Kraay, 2008). It was liberally used by the donor community to “name and shame” countries that failed to live up to the standards associated with this and other indices such as the Corruption Perceptions Index that serves as a major input into the *Global Corruption Report* published annually by Transparency International.

More recently, influenced by the difficulties of converting data from these indices into specific policies and fuelled by changing perceptions of foreign aid, as confirmed in such documents as the 2005 Paris Declaration and the 2008 Accra Agenda of Action, understanding governance has moved in the direction of (a) viewing it as a political rather than a managerial challenge, (b) treating it as a country-owned rather than a global and externally driven project, and (c) acknowledging that institutional performance is determined by underlying political economy variables (Organization for Economic Cooperation and Development-Development Assistance Committee, 2008).

Development, ever since the early 1980s, has been interpreted through a microfoundational model of choice. The global discourse and practice have centred on getting policies right and making institutions more efficient and effective in using and allocating resources. This approach has until recently remained unhinged from the varying structural realities of the many countries in the South. It has encouraged a tendency to assume that a single policy solution fits everywhere, is a matter of right design, and is expected to produce results regardless of circumstances.

More recently, there has been a growing recognition of what the international policy community took for granted in the 1960s and 1970s: the idea that development is a historically embedded process (a comparison of modernization and underdevelopment theories of those days) and thus determined as much by structural factors as by rational choice. This has led a number of donor agencies to change their approach to foreign aid and its role in development. In the name of greater aid effectiveness, there is a tendency to (a) encourage greater national ownership of foreign aid by recipient countries, thus tempering the “econocratic” approach to policy design with political process considerations; (b) assess progress in trajectory terms, that is, understanding where a country comes from and what progress it has made rather than comparing it to other countries; and (c) shift from a model-driven to a problem-driven approach to development (for an example from the World Bank, see Fritz, Kaiser and Levy, 2009). This change is also evident in the critique offered by heterodox economists like Khan (2007) who believe that too much emphasis in the past has been laid on making the system more efficient at the cost of making it more effective in transforming the productive forces in society.

With regard to poverty reduction or eradication there has been a corresponding shift in perception and approach. For the past ten years, until recently, the effort

has been driven by the complementary role that reducing poverty is expected to play in the context of the macroeconomic changes towards a neo-liberal model of development. It has been fuelled by international proclamations like the Millennium Development Declaration, donor-driven strategy formulation, and debt-relief funding that made it convenient for donors to set aside resources for the low-income countries of the world. Poverty reduction has been an integral part of official development assistance (ODA) and its emphasis on government-to-government transfers. The State—or various government institutions—therefore, has been the principal recipient of the resource transfers for poverty reduction. In many respects, the strategy adopted for poverty reduction has been an echo of the basic needs approach that dominated in the 1970s.

A number of bilateral donors, accepting like the International Labour Organization (ILO) that employment has been a neglected issue in reducing poverty, have more recently shifted their priority to job creation. Initiatives that promote economic growth—or income growth at the individual level—have been given greater weight in the policies of Nordic Governments. An example is the Danish *Africa Commission Report* of 2009, which stresses the importance of job creation for the poor, especially the unemployed youth. The follow-up to this report is Danish sponsorship of a number of regional and national projects focused on poverty reduction through job creation. This does not signal a return to a complete reliance on the market as in the 1980s and 1990s but a better balance between the contributions that come through interventions by the State or through the market.

These shifts in perception and practice are part of an ever-changing development narrative. They are important because they constitute, in many respects, a challenge to many of the premises underlying the poverty eradication efforts that became mainstream in the early 2000s. They call for caution where the MDGs demand acceleration. They call for attention to process where the MDGs demand results. They call for appreciation of local context and ownership where the MDGs demand attention to global targets. They call for “best fit” arrangements where MDGs call for “best practice” interventions. They call for understanding structural variables where the MDGs demand fixing institutions. These juxtaposed positions are not necessarily irreconcilable but they do constitute challenges to the final phase of implementing the MDGs.

Addressing the challenges

These challenges call for reviewing the approaches to poverty reduction at both donor and recipient ends. The bottom line must be how policies can be made more effective given the shifts in understanding of governance, development and poverty reduction that have taken place since the MDGs were first launched.

At donor level

There are two issues that deserve attention at the donor level. The first is the extent to which the MDGs have become an end in themselves, compared to being a means to an end. The second is what the balance should be between the focus on development and poverty reduction as compared to governance.

MDGs—ends or means?

The MDGs have become a powerful catalyst for global efforts to reduce poverty with a special focus on low- and middle-income countries. Countries around the world have gathered together to act in a way that is rather unique at least in recent United Nations history. Governments in the North and the South alike have subscribed to the MDG agenda. Civil society organizations have joined the effort and added value through their own national and international networks. Although more a framework for action than a specific strategy, the Millennium Declaration has replaced the Washington Consensus as the lead for global action.

A particular feature of the MDGs is that there are specific targets that should be met within the time agreed upon for eradicating poverty—fifteen years (2015). While *eradication* of poverty is a noble aim of promoting social justice—and should be kept for that reason alone—*reduction* is a more realistic ambition. Each of the eight Goals derived from the Declaration reflects this more pragmatic approach. Even so, implementing these goals is a momentous task.

Commitment to implementation has been strong all around. The donor community has made funds available on a scale that may be unique for United Nations–led development ventures. This financial commitment has been matched by a high level of political dedication. Implementing the MDGs has been turned into “Job No. 1” in many bilateral aid agencies.

While this resoluteness is commendable, it has also led to a somewhat one-sided approach. First of all, the focus on implementation has encouraged a managerial approach that neglects the differences that exist in context from one country to another. Individual countries and regions of the world have been compared as if they began from similar premises. Little, if any, attention has been paid to the question of where a country started from and what distance it has travelled on the way to implementing the Goals (Go and Quijada, 2012; Easterly, 2007). Second, this attempt to benchmark these goals for national planning purposes without adequately contextualizing and tailoring them to national circumstances and capabilities has been criticized—even by one of the MDG architects, Jan Vandemoortele. In his view, the MDGs have been turned into a master rather than being a servant to national policy implementation (Vandemoortele, 2009; 2011).

Governance—the overlooked variable?

The often blind focus on implementation reflects the prevalence of a results orientation among the donors. This has become increasingly pronounced since the MDGs were first adopted. The principal interest has been in identifying outcomes that can be attributed to the financial and programmatic support given by the donors (Vandemoortele, 2011). The more important question has been what has been achieved, not necessarily how it was achieved.

Being a process variable, governance has been, if not an afterthought, nonetheless often an issue of secondary interest. Good governance is not included as one of the MDGs. Furthermore, the process is complex and messy and thus difficult to measure. Getting institutions to work well takes time and their maturation does not easily lend itself to evaluation within the budgetary timelines of donor Governments. For these reasons, there has been a tendency to rush the implementation in ways that have not always been positive. For instance, building schools in the rural areas of many African countries has been accelerated to the point where the public revenue to maintain these structures, for hiring teachers and obtaining educational resources, is often woefully insufficient (Therkildsen and Buhr, 2010). The result is that students enrolled fail to graduate, and drop out of schools with little knowledge. According to the Minister of Education of the United Republic of Tanzania, no less than 46.5 per cent of all pupils failed to pass their Standard Seven national examinations in 2010. Even though the total number of pupils enrolled is much higher than before, this still means that after seven years of schooling, almost half remain largely illiterate and unable to function better in society (Lugongo, 2010).

The role of governance in development and poverty reduction is complicated by the fact that the global discourse tends to use the concept in many different ways. Particularly unhelpful is the suffusion of policy with governance. For instance, in many agencies, good governance is tantamount to right development policy. To fully appreciate the role that governance can play in reducing poverty, it is important to make a distinction between public policy, on the one hand, and governance, on the other. Public policy is made—and implemented—within a governance framework. The latter can facilitate the policy process, but it may also hinder it. Thus, the challenge is to develop the rules or institutions that promote poverty reduction.

This task has become more demanding in recent years as the international community has raised the bar by insisting on multiple stakeholder involvement in making and implementing policy as well as by calling for attention not merely to results but also to rights. This has meant a radicalization of the approach to poverty reduction that not every donor finds easy to embrace in full. Several dimensions of governance, therefore, are often overlooked because the human rights agenda is politically controversial in inter-State relations. This being said, it is also important to record the progress that has been made towards an acceptance

of a human rights–based approach to poverty reduction. This was noted as one of the achievements at the 2010 MDG Summit. What is clear is that governance issues, not least those of social justice and human rights, are becoming increasingly salient within the donor community as it considers poverty reduction approaches.

At recipient level

Poverty reduction, especially when linked to the MDGs, is an international project with its own global framework. In implementing it, not enough attention is always paid to the differences on the ground in the countries of the South. Two issues pose challenges in the effort to meet the MDGs. The first is the structural factors that often make policy implementation fall short of target in many low-income countries. The second is the weakness of the indigenous middle class when it comes to creating jobs and formalizing the relations of the informal sector.

What does digging down reveal?

The value of political economy analysis is that it allows for a deeper digging down than one focused on policy and institutions alone. It has become a necessary part of understanding why policies fail to get traction, especially in low-income countries. There may be nothing wrong with the design of the policy, nor the willingness to implement it, but a given initiative still falls short of full realization because there are structural obstacles. Structural variables are slow-moving, that is, it is unrealistic to expect that they will bend to policy initiatives right away. They take time to conform to and facilitate the reforms that policymakers seek.

Of special relevance is the fact that low-income countries lack rationally constructed systems for policy execution. Poverty exists in many forms and arises in a broad range of circumstances. The causes may be man-made and systemic or they may be environmental, meaning people may live in poverty because they are not part of a system. In other words, poverty may be the result of effective as well as ineffective policy interventions. Policies tend to be effective where interdependent systems exist, it is possible to rationally coordinate and direct collective action in a certain direction, and people are sufficiently dependent upon the system to “feel the pinch”. This is what is needed to redress mistakes and ensure a policy dynamic that responds to what happens to citizens in a particular country. The instrumental rationality that is required for the system to work is what helps produce the conditions under which development becomes sustainable. Countries that have emerged from low- to middle-income status or are already developed have all acquired this quality and used it as an engine of economic growth as well as redistribution.

Countries that are lagging in terms of eradicating poverty are those that lack the qualities needed for systems strategies. Leaders use personal and informal relations to govern, and citizens are not sufficiently captured by the market to respond in terms of rational choices that enhance their position in society. Individuals use

personal connections to enrich themselves or cope with the conditions of their poverty. Human rationality, and therefore, by extension, policy interventions do not penetrate society in the same dynamic manner as in societies that have fully embraced such an approach. For example, poverty eradication policies tend to get implemented with little regard to feasibility and cost-effectiveness because there is no rational feedback or citizen response that makes the system avoid similar mistakes in the future. Leaders act like chiefs, people respond as subjects, and the future is seen to lie in the hands of forces over which they perceive themselves as having little control. Community-based projects work in these contexts but these efforts tend to become isolated islands and often falter once the external input comes to an end.

When it comes to poverty eradication and understanding the developmental context in which it is being pursued, there are, from a governance perspective, two basic and distinctly different scenarios: one where systems work and policies can be assessed in terms of specific gains or losses and another one where systems do not work or are still in the making and policies therefore tend to slip and meaningful and sustainable results are hard to identify. These two scenarios can be further differentiated between those where either the State or the market tends to be the prime mover when it comes to poverty eradication, as illustrated in figure 3.1 below.

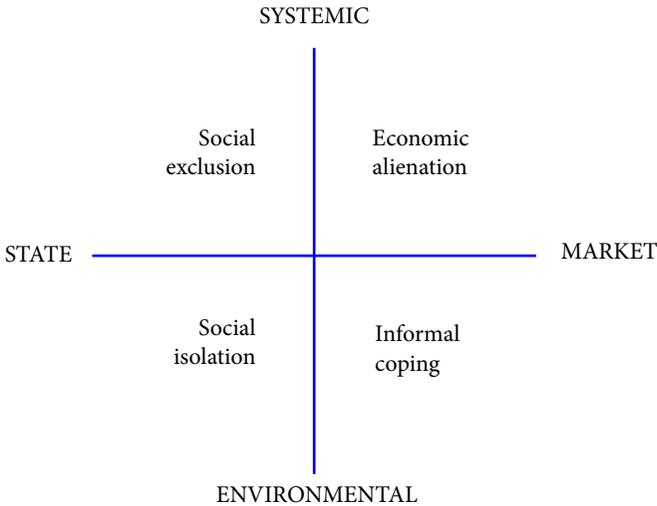
Systemic rationality is modern and encourages adherence to abstract principles and rules. It creates solutions that are meant to apply universally regardless of context. Rule of law, human rights and the perception of the individual as an autonomous actor with capacity to determine his or her own destiny are among the more obvious manifestations of this type of rationality. As Giddens (1990) argues, it is “disembedded” from place and time. It is being constrained by systemic rules that make calculability possible. The effects of poverty eradication policies, therefore, are possible to measure and, if necessary, correct.

Where systemic rationality is lacking or not strong enough to decisively determine the outlook of the policy elite, environmental conditions shape the outcome of various initiatives and interventions. These conditions are typically non-modern: a belief in supernatural forces controlling human destiny; a preference for face-to-face interaction; a respect for patriarchal authority; and a reliance on particularistic rather than universalistic norms. Policy preferences reflect differential environmental conditions. Because people do not have a sense of sharing their destiny with others outside their own community, they tend to become disappointed when government is not giving them everything they ask for because it must share scarce resources with people in other communities. This has proved to be a serious challenge in trying to effectively implement participatory or “bottom-up” budgeting aimed at empowering the poor. The point is that in these circumstances, local community priorities tend to get dropped at higher levels and the feedback from these higher levels back to the communities tends to come with only the message that “there was not enough money in the budget

to include your project”. In these circumstances, it is not particularly surprising that the poor try to fast-track their request by engaging a political patron. The phenomenon of clientelism, therefore, should not be viewed as merely driven by powerful individuals. In the context of trying to get out of poverty, it is also driven from below by the poor because there is no system to really incorporate them in a civic and constructive way.

Having laid out the parameters for identifying different manifestations of poverty, the next step is to provide some empirical examples of countries that fit the descriptions in the matrix. *Social exclusion* tends to be most prevalent in two scenarios. The first is in countries that already rely on a universalized State but face challenges from groups that call into question existing norms of governing. In the case of Canada, for example, this has occurred with the growing activism on the part of indigenous peoples. In Europe, it has occurred as a result of immigration of people from other cultures. The most apparent case is the Roma people, but it applies to other groups as well. The response has vacillated between a softer multicultural approach and a harder insistence on existing universal norms. France’s response to cultural challenges from its Muslim minority is a case in point. Policies aimed at correcting gender inequalities constitute yet another example of how political measures have been taken to extend universal norms to all groups in society (Narayan and Petesch, 2007).

Figure 3.1. Types of poverty manifestations depending on governance context



Source: Author’s own elaboration

The second scenario is in countries that are modernizing and trying to universalize norms in ways that leave certain groups outside the mainstream. In Botswana, for example, where the Tswana-speaking majority has modernized the State and its system of making and carrying out policy, the Basarwa and Weyeyi groups of people in the northern part of the country have become increasingly excluded (Nyati-Ramahobo, 2008). Much the same happens in other countries undergoing this process. In India, the victims tend to be ethnic peoples that depend on social activists rather than the State to be part of society. Indigenous people in Latin America are yet another case in point. In many of these countries, as in the United States of America before, these minorities have been brought onto reservations so as to be more easily approached by the authorities.

Economic alienation occurs when people are uprooted from their land and forced into employment either on somebody else's land or in new social settings such as industries. In the classical analysis of alienation, the process was seen as the cause of poverty and powerlessness. This was confirmed by upheavals and revolutions in Europe in the nineteenth and at the beginning of the twentieth centuries, but was gradually brought under control. People leaving the land by the 1950s in Europe had become a natural process of escaping poverty. Alienation, however, was also an integral part of creating the conditions for development. As part of modernization, the process had the effect of making people more dependent on a system that could be adjusted in response to market or bureaucratic failures (Kohli, Moon and Sorensen, 2003). Greece is a recent example of where the governance of the system has failed to the point where the poor have taken to the streets to protest. A similar process of economic alienation has been intensified in many parts of the world since the introduction of neo-liberal economic policies. Although it has not always crystallized into social class formation, the social dynamic that stems from the penetration of the market has grown in importance. It is the disjuncture between the social differentiation in the marketplace, on the one hand, and the sluggishness of the governance sphere, on the other, that has led to the uprisings in the Arab world. In short, the operational demands of the economic system cannot be ignored. Wherever governance measures fail to respond to these demands with an eye also on their human consequences, poverty is likely to increase and with it the risk of protests going out of control.

Social isolation is different from social exclusion and occurs where social interaction is not perceived in rational and objective terms. In other words, poverty is not foremost an intentional outcome of specific policies but a consequence of particularistic preferences in resource allocation. The phenomenon of social isolation seems particularly prevalent in multi-ethnic societies. The isolation of nomadic people by sedentary groups of agriculturalists in African countries is one case in point. There are other examples not only from Africa but other regions as well where similar particularistic norms based on religion, ethnicity or race lead to social isolation and a state of poverty. The worst examples are those where the system is so inadequate in bringing people into a functioning economic system

that it produces the “failed State” phenomenon. The social fragility associated with this scenario is a significant contributory factor to poverty, as the *2011 World Bank Development Report* shows. Social isolation therefore stems from some people being denied the same opportunities as others and is a consequence of developmental conditions that are still infused with non-modern norms and where, for example, physical infrastructure is lacking and thus exacerbates the situation.

Informal coping occurs in situations where market institutions are inadequate in serving people. It is a manifestation of poverty because there are not enough levers to lift people out of poverty or access to them is difficult, if not outright denied. People in the informal sector may be trying very hard to succeed; many of them are entrepreneurs but their aspiration and ambition are not sufficiently supported by the system. In many African countries, this issue arises because of the continued existence of customary rules of asset ownership that limit the issue of credit. Following the initiative several years ago by Hernando de Soto in the informal sector in Lima, Peru, efforts have been made in select African countries to work towards regularizing asset ownership in the informal sector, and some progress has been made. For the majority of the poor in the informal sector, however, things have not changed and “graduating” from poverty status is still a long way away. Microcredit systems similar to the Grameen Bank in Bangladesh have been tried and many projects have alleviated the worst forms of poverty, but few have had the effect of helping the poor to become full participants in an economic system where they can decide the future on their own. Above all, the very few examples of collective action by the poor in response to challenges posed by the economic system would indicate that they have not yet moved from merely coping to being willing and able to take organized steps to change the system.

Lessons learned

Governance is relatively easy in countries with functioning economic systems because they have the mechanisms for generating development and reducing poverty. These are countries that have fully embraced modern values and norms of rationality. Even though progress is never linear, what characterizes these countries is their ability to self-propel. They respond to specific policy interventions and can correct what goes wrong.

The real challenge lies with countries where these qualities are still in short supply and thus fail to produce the systems strategy capabilities that have been referred to above. Universal policy prescriptions fail to get traction. It becomes difficult to create the sense of ownership and commitment to policy that these universal policies call for. The results expectation is not adjusted to the capabilities of the institutions of these countries. They are therefore inevitably described as

falling behind or failing to reach the goal. In the name of accelerating the effort, these countries are induced to expand their social services sector to a point where there is a great risk that they cannot meet the recurrent costs of sustaining any gains made (Therkildsen and Buhr, 2010).

The inclination of the international policy community to deal with these institutional capability issues has been to transfer models and practices from already functioning systems. These implants have been hard to sustain because universal, abstract models do not work in particularistic settings. These are two distinctly different governance regimes. What has been missing in the prescriptions to date is a sense of history, notably with reference to how a State is formed and how it functions at different developmental stages. The prevailing assumption in the public choice model that has served to underwrite so much of the policy in the past three decades is that the State is autonomous and free from corruptive private interests. From a historical perspective, it is clear that the State has never been a neutral instrument for good only, but has been the subject of power struggles. It is only out of such struggles that it has eventually emerged in the shape that we now use as the model of good governance. The destiny of the State has been determined by local stakeholders with an interest in improving governance. Wherever systems capabilities remain weak, the fate of poverty eradication will be determined by the extent to which modernizing social forces will grow and establish themselves as architects and builders of a self-sustaining system and governance regime. In the meantime, it is necessary to reduce the influence of particularistic norms by steering resource flows to the poor via channels that encourage professional management of funds according to universally acceptable norms.

Policy recommendations

Many of the countries that have found it difficult to meet the MDG goals are also highly aid-dependent. The responsibility for their shortcomings, therefore, must be shared by the development partners. Because ODA goes through the principal treasury institution, it feeds central government institutions. Since these institutions in many countries plagued by widespread poverty do not act in a strategic and rational fashion, aid money tends to get tied up in red tape or misappropriated. Local government institutions that are closer to addressing poverty issues are starved of funds and rarely get them on time. For example, most African Governments have an 80/20 formula for sharing expenditures—four fifths going to central Government, one fifth to local governments. This is a serious misallocation of funds that has not been possible to correct despite pressure to decentralize funding and the establishment of special means to track public expenditure. This formula not only generates governance problems, such as incidents of corruption, but also sustains a centralized, top-down approach to

development that does little to reduce poverty and fails to satisfy current principles of how aid money should be utilized. Above all, it does nothing to reduce the influence of particularistic norms in resource allocations.

A new approach is needed as part of an emerging development narrative in order to strengthen poverty reduction efforts in these countries. It should be designed in accordance with the following simple but basic principles: (a) it must be demand-driven; (b) it must cater to local institutions, governmental or non-governmental; (c) it must be independent of direct presidential or ministerial control; and (d) it must be professionally managed by an autonomous board of directors or trustees. The operational formula for such funds has been around for some time and there are examples to show that it works (Dag Hammarskjöld Foundation, 1995). The benefit of this approach is that it provides incentives for local stakeholders to adopt universalistic principles for managing their affairs and reduce their adherence to particularistic norms, including reliance on political patrons.

A second recommendation concerns the geographic focus of poverty reduction programmes. To date, the emphasis has been on rural poverty based on the assumption that the majority of the poor live in the countryside. This, however, is rapidly changing. More and more young people, especially in African countries, are moving to the cities, in most cases triggered by the education that they have received in the village. A primary or secondary school certificate has become a passport to urban living to most young people. Poverty reduction programmes in the rural areas, therefore, have helped push the poverty problem to the cities.

Building schools and health centres as well as reducing infant mortality and other related activities are the easy part of poverty eradication. They produce figures to make it possible to measure outcomes. They encourage a sense that poverty reduction is a managerial and technical task. Dealing with urban poverty is more difficult. It is more complex, messier and politically contested. Yet, it is in the cities, large and small, that the real challenges of poverty reduction lie in the near future. Tackling urban poverty issues not only requires a different focus, but also calls for governance measures that help overcome ethnic and other forms of particularistic conflicts that cause displacement, and by extension, poverty. What happened in Kenya in 2008 and more recently in Côte d'Ivoire, two countries that have generally been regarded as economic success stories, provide a warning that urban poverty is a potential time bomb that can explode with disastrous consequences for development.

References

- Dag Hammarskjöld Foundation (1995). *Autonomous Development Funds: Report from an Expert Meeting*, Kampala, Uganda, 4-6 April. Uppsala: Dag Hammarskjöld Centre.
- Danish Ministry of Foreign Affairs (2009). *The Africa Commission Report*. Copenhagen: Ministry of Foreign Affairs.
- Easterly, William (2007). How the Millennium Development Goals are unfair to Africa. Brookings Global Economy and Development Working Paper 14. November.
- Fritz, Verena, Kai Kaiser and Brian Levy (2009). Problem-driven governance and political economy analysis: A good practice framework. Washington, D.C.: World Bank. September.
- Giddens, Anthony (1990). *The Consequences of Modernity*. Stanford, CA: Stanford University Press.
- Go, Delfin S., and José Alejandro Quijada (2012). The odds of achieving the MDGs. *The World Bank Research Observer*, vol. 27, No. 2, pp.143-184.
- Kaufmann, Daniel, and Aart Kraay (2008). Governance indicators: Where are we, where should we be going? Policy Research Working Paper No. 4370. Washington, D.C.: World Bank.
- Khan, Mushtaq (2007). Governance, economic growth and development since the 1960s: Background Paper for the *World Economic and Social Survey 2006*. DESA Working Paper Series No. 54. New York: Department of Economic and Social Affairs, United Nations.
- Kohli, Atul, Chung-in Moon and G. Sorensen (eds.) (2003). *States, Markets and Just Growth: Development in the 21st Century*. Tokyo and New York: United Nations University Press.
- Lugongo, Bernard (2010). 47pc of candidates fail exam. *The Citizen*, 5 December. Available from <http://www.thecitizen.co.tz/news/4-national-news/6080-47pc-of-candidates-fail-exam.html>.
- Narayan, Deepa, and P. Petesch (eds.) (2007). *Moving Out of Poverty*. Washington, DC: World Bank.
- Nyati-Ramahobo, Lydia (2008). *Minority Tribes in Botswana: The Politics of Recognition*. London: Minority Rights Group International. December.
- Organization for Economic Cooperation and Development-Development Assistance Committee (2008). *Survey of Donor Approaches to Governance Assessment*. Paris: OECD-DAC Network on Governance. Available from http://www.polypixel.de/testsite/inwent_lg/download_05/Survey_donor_approaches.pdf.

Therkildsen, Ole, and Lars Buhr (2010). Recurrent cost boom threatens Millennium Development Goals. Elites, Production and Poverty (EPP) Project, Danish Institute for International Studies, Copenhagen, November.

Vandemoortele, Jan (2009). The MDG conundrum: meeting the targets without missing the point. *Development Policy Review*, vol. 27, No. 4, pp. 355-371.

_____ (2011). The MDG story: Intention denied. *Development and Change*, vol. 42, No. 1, pp.1–21.

World Bank (2011). *World Development Report 2011: Overcoming Conflict and Fragility*. Washington, D.C.: World Bank.

Chapter 4

Agriculture, rural livelihoods and poverty eradication: some policy lessons from the food price crises

BETTINA PRATO²²

INTRODUCTION

The role of agricultural development as a driver of inclusive growth and poverty reduction has regained policy attention since the mid-2000s. In addition, today agriculture is increasingly seen as a provider of other major development goals—notably food security, improved nutrition, more resilient ecosystems and climate change mitigation. Though not yet fully recognized, the potential for agriculture to drive inclusive growth, reducing poverty on a large scale in the coming years particularly in rural areas, is linked to its ability to deliver on these other goals. However, in the aftermath of two global food price spikes and in the midst of growing climate instability affecting harvests, we are only beginning to see some convergence between discourses on agriculture as a driver of poverty reduction and those that link it to food security and nutrition, climate change mitigation, or a “green economy”.

While the importance of agriculture is thus increasingly emphasized in eminent publications and in policymaking circles, this same sector has been less and less able to provide a sufficient, stable income source for the roughly 2 billion people who belong to farming households in the developing world. This is partly due to a shrinking and impoverished natural resource base, partly to population growth, and partly to social and economic changes encouraging or necessitating rural livelihood diversification. Particularly in some regions, most very poor people continue to be rural, and rural poor women and men are disproportionately

22 Research assistance from Samadhi Lipari (consultant, International Fund for Agricultural Development) is gratefully acknowledged.

represented among the undernourished. While this may not be true for long, today agriculture is the main available livelihood strategy, or an important complement to other income sources (as well as, in many cases, the driver of other income opportunities), for most of these people. Underinvestment in agriculture remains one important reason why rural poverty is still widespread and entrenched in many areas. Just as important as sector-specific investment, however, is inadequate investment in rural services, institutions, and infrastructure, as well as in the capabilities of poor rural women and men as social and economic agents. Increasingly, failure to respond to new risks and vulnerabilities affecting both rural areas and agriculture is also a major factor hindering inclusive, poverty-reducing rural growth.

Given all this, what do the food price crises signal to policymakers tackling the challenge of eradicating rural poverty? Essentially, they point to a global food supply–demand imbalance set in a context of rapid, ongoing transformations in agricultural markets around the world. This context and imbalance entail both challenges and opportunities for agriculture and for inclusive rural growth. The challenges are linked to increasing risk of marginalization of poor rural people in agricultural markets, which are changing fast to cater to growing demand in high-value sectors and in urban areas. They relate to risks of poor households losing their rights over natural resources, as these acquire greater market value and attract larger investors. Challenges are also linked to pressure on the productive capacity of farmers caught between a more fragile environment and more demanding markets. They are, finally, related to the vulnerability of rural livelihoods to new risks and shocks—price spikes included. There are, however, also important opportunities linked to market transformations and to the supply–demand imbalance that underlie recent price volatility. These are related to growing demand for agricultural goods and services (which can create income opportunities for farmers and other rural workers) and to the growing interconnection and reorganization of markets and supply chains (which can broaden and diversify those opportunities). They are linked to the slow emergence of reward systems for improved management of ecosystems, which can bring new sources of income and foster dynamics of sustainable economic growth in rural areas. Finally, the prominence of food security and nutrition on policymakers’ agendas in recent times—partly fuelled by the food price spikes—offers an opportunity to direct more resources and policy attention to agriculture, and hence to rural areas.

Against the backdrop of the crises, one critical question²³ that policymakers tackling rural poverty must address is thus the following: how can poor rural women and men be supported to harness opportunities linked to growing market demand around agriculture, while strengthening their resilience to shocks, and with greater focus on their food security?

23 Other critical questions concern creating opportunities in the non-farm rural and urban economies for rural poor people and harnessing migration flows to boost inclusive growth. These are already critical questions today for millions of people. However, given the narrow topic of this paper they are not addressed here.

Clearly, this question requires more than policy responses. However, policy factors are critical: sound policies are needed to create an enabling environment for investment in agriculture and the non-farm economy. A policy agenda is needed to support smallholders to shift to agricultural practices that are more productive, sustainable and resilient, capable of meeting growing demand for high quality food and of better withstanding environmental pressures. Also, there is need for policies to mitigate the risks rural people face and to reduce their vulnerabilities. The crises point, in particular, to the importance of food and nutrition-centred safety nets²⁴ and of policy initiatives to reduce risks facing small agricultural producers, rural workers and their households. Combining policy initiatives coherently in these areas requires joint actions across ministries, levels of government, and stakeholder groups. It requires a focus on agriculture, but in the broader context of improving the economic and social environment of rural areas, mitigating the risks poor rural people face, and nurturing their capabilities to take advantage of changes in agriculture and in rural markets.

Rural poverty, rural livelihoods and agriculture

According to the International Fund for Agricultural Development (IFAD) Rural Poverty Report 2011, 1 billion people among those living on less than \$1.25 a day are rural dwellers (International Fund for Agricultural Development, 2010). Despite rapid urbanization under way across the developing world, a majority of poor people will continue to be in rural areas in the next decades. The picture is, however, different across regions and countries, both in terms of urbanization and of the relative share of rural and urban populations among the very poor. In Latin America and the Middle East, most poor people live in urban areas. Over three quarters of people living below \$1.25 a day are in rural areas in sub-Saharan Africa, South Asia and Southeast Asia. In the second half of the 2000s, over 80 per cent of those living in extreme poverty in South Asia were rural (International Fund for Agricultural Development, 2010) In addition, about one third of the rural population of developing countries live below \$1.25 a day, and more than 60 per cent on less than \$2 a day. In sub-Saharan Africa, over 60 per cent of rural people live in extreme poverty, and nearly 90 per cent live on under \$2 a day (International Fund for Agricultural Development, 2010).

Looking at poverty as a multidimensional problem does not yield a rosier picture: across the developing world, rural areas are at a disadvantage when it

24 Safety net programmes may include non-contributory transfers of cash or food, which may be unconditional or be delivered upon condition that children are kept in schools, that work is undertaken in exchange, that medical checkups for infants and children are performed regularly, or other conditions. They are generally targeted to population groups meeting specific criteria. Some non-targeted or difficult-to-target types of initiatives, such as food subsidies, may also be considered to be safety nets, but they are not dealt with here.

comes to services and infrastructure of critical importance for development, from energy to roads, from drinking water to sanitation, from healthcare services to education. For instance, over 1.6 billion people are reported to lack access to electricity, the vast majority of them in rural areas (Carr and Hartl, 2010). Only a couple of years ago, the United Nations Development Programme (UNDP) estimated that the number of people lacking access to electricity and modern fuels was expected to grow, notably in least developed countries and in sub-Saharan Africa, with major negative impacts particularly on rural women (United Nations Development Programme, 2009). Rural children also have less access to good quality education opportunities or less of a chance to stay in school than their urban peers, and rural girls less than boys (United Nations Educational, Scientific and Cultural Organization, 2010). In general terms, the same can be said about access to health care, financial services and opportunities for political participation. To no small extent, spatial inequalities underlying rural poverty result from urban bias, or a relative neglect of rural areas, people and economic sectors in public policies and investments. Weak human and collective capabilities and the fragmentation of agricultural production systems, on the other hand, weaken the ability of poor rural people—especially women and minority groups—to influence public budgets and investments.

As noted at the outset, poor rural households today have diverse sources of income, although livelihood diversification is unequally prevalent across regions—more so in Latin America and Asia, less in sub-Saharan Africa. In India, for instance, almost one third of the rural labour force is in the rural non-farm economy, mostly in casual employment, with salaries typically higher than in agriculture, but generally not sufficient—or stable enough—to exit from poverty (Himanshu and others, 2010). Yet, the majority of poor rural households still have livelihoods that rely on agriculture—as a source of income, a risk-mitigating strategy, or a source of food and other items for household consumption (International Fund for Agricultural Development, 2010). Also very importantly, many rural non-farm jobs are in activities ancillary to agriculture—related to input supply, processing, transportation and marketing. Depending on household gender roles and on existing opportunities, different activities in or outside agriculture may be more important for poor rural women or for men in each context. In general, women are estimated to make up about half of the agricultural labour force in sub-Saharan Africa and East Asia (Food and Agriculture Organization of the United Nations, 2010a). However, in some regions they are prominently represented among non-farm workers, for instance in food processing. Going forward, fewer and fewer households will be able to make a living entirely based on agriculture, owing to population growth and a shrinking resource base. However, in some regions, notably sub-Saharan Africa, non-farm (or urban) opportunities that may absorb a growing labour force will remain insufficient in the near future. Even elsewhere, tapping agricultural growth to provide opportunities for inclusive, job-rich rural growth in ancillary sectors is likely to be a priority for many years to come. Redressing urban bias is, however, necessary for this to occur.

In parts of the world where rural poverty is more prevalent (notably sub-Saharan Africa) or where poor rural people are more numerous (notably South Asia), the overwhelming majority of agricultural holdings are small (and are often getting smaller), and the main production system is based on family labour.²⁵ Smallholder agriculture, however, includes a variety of farming practices in diverse landscapes and on a diverse resource base. It includes crop farming but also livestock production, artisanal fishing, aquaculture and forestry. It encompasses the production of food, fibre, fuel, medicinal products and other goods and services. In a context of growing global preoccupation with food security and food prices, it is important to note that up to 80 per cent of food consumed in Asia and sub-Saharan Africa is produced on small farms, which, however, host about half of the undernourished in the world (Hazell and others, 2007).

By and large, poor smallholders (especially women farmers) operate on a limited asset base in terms of land and other natural resources, equipment and financial capital, with inadequate access to agricultural technology, extension and advisory services, inputs and services (International Fund for Agricultural Development, 2011). Like other rural citizens, moreover, they suffer from the underdeveloped state of rural infrastructure and services, as well as from unequal opportunities for political participation and limited influence on policymaking (Prato, 2009). In this, they are just as held back from participating in inclusive economic growth as are small entrepreneurs and workers in other rural sectors. As agricultural producers, they also have to face poorly organized and/or highly asymmetrical agricultural markets, and high transaction costs for market access and participation—especially in urban and modern retail markets (Vorley and Proctor, 2008). This is not to deny that in some countries smallholders and agricultural workers are active in modern supply chains serving domestic or export markets, often with a positive impact on poverty (Swinnen, Maertens and Vandeplas, 2010). However, in many areas the development of modern supply chains, coupled with a legacy of weak market institutions and poor infrastructure and services, has not occurred in ways broadly inclusive of smallholders, nor has it brought about the sort of decent job-creating process that can contribute to rural poverty eradication.

Given the centrality of agriculture in the livelihoods of poor rural people, it is not surprising that economic growth in this sector tends to generate the greatest benefits for poor people, particularly those in low-income countries. One source shows that growth in agriculture is up to 3.4 times more effective at reducing extreme poverty than growth in other sectors (Christiaensen, Demery and Kuhl, 2010). Other sources state that growth in agriculture—especially smallholder agriculture, and especially where land ownership is more equal—is at least twice as beneficial to the poorest people as growth in other sectors (Food and Agriculture

25 However, among the about 500 million farms of less than 10 hectares, or the about 450 million below 2 hectares, not all are farmed entirely with family labour, and family farms can be much larger than 10 hectares in parts of the world, notably Latin America.

Organization of the United Nations, 2009). In recent decades, countries where vast progress has been made in reducing extreme poverty—for example, China, Viet Nam, other countries in East and Southeast Asia—are ones where smallholder agriculture has played a major role in driving inclusive growth.²⁶ In recent times, agriculture has played an important role in growth and poverty reduction also in some African and Latin American countries, such as Ghana and Brazil. Agricultural development has also been instrumental in reducing the number of the hungry in these and other countries—from 303 million in the period 1979-1981 to 122 million in the period 2003-2005 in China, or from 262 million to 231 million during the same period in India (Spielman and Pandhya-Lorch, 2009). It has enabled such achievements by increasing food availability through improved supply, improved nutrient quality, increased farmer incomes, and lower food prices for poor urban consumers.

Many stories of growth and poverty reduction driven by agriculture are linked to the history of the “green revolution” in the 1970s-1990s. This encompasses the development and popularization in several Asian and Latin American countries of improved seeds and crop and livestock varieties, combined with increased use of agrochemical inputs, land tenure reforms, price management policies, and public investment in rural and agricultural infrastructure (irrigation, roads) (International Fund for Agricultural Development, 2010). Today, many call for a replication or extension of these approaches to areas where the green revolution did not reach—notably in Africa. However, in many areas traditional green revolution approaches have had significant negative externalities or have reached their limits in environmental and social terms. Also importantly, the leading role of the public sector in boosting agriculture under the green revolution, and some of the policies implemented in that context by several Governments (notably concerning price stabilization and public marketing), do not lend themselves to easy replication in today’s circumstances.

It is apparent today that there is a need to scale up investments in agriculture to move beyond the green revolution, to continue on its path in terms of research and development (R&D) and technology dissemination, and also to further a new agenda for sustainability and resilience. It is also clear that both public and private investment are needed for this, given the magnitude of the task at hand, and the fact that most investment in agriculture is private anyway—coming in particular from farmers—but requires supporting public investments and policies. Today, investment in agriculture is inadequate in many developing countries. One estimate of the needed additional public investment in agriculture for meeting the first Millennium Development Goal (MDG 1) amounts to US\$ 14 billion a year from 2008 to 2015 (Fan and Rosegrant, 2008). It is harder to estimate the

26 For instance, rural poverty rates declined in China from 76 to 12 per cent between 1980 and 2001, driven by a combination of policies boosting agricultural production, while rural poverty declined from 64 to 34 per cent in India between 1967 and 1986 (see Chen and Ravallion, 2007).

investments in a range of sectors that agriculture needs in order to thrive (and to help eradicate poverty under today's circumstances). What is clear is that more resources need to go in and around agriculture to support the kind of inclusive growth that can help eradicate rural poverty. Policymakers have critical roles to play in making this possible—via public investments in specific areas, and by designing, implementing and enforcing enabling policies to ensure not only that greater investment does occur, but also that it does so in ways that are conducive to enabling agriculture to drive inclusive growth and to deliver on a range of development goals.

The price crises and smallholder farmers

After about three decades of relatively stable, overall low food prices, global food markets have experienced a resurgence of volatility, accompanied by two significant price spikes between 2006 and 2011. The first global price hike took place in the period 2007-2008, affected virtually all internationally traded food commodities, and was followed by a relative stabilization of prices at higher levels than in previous years. The more recent one began in mid-2010 and had built up more unevenly across countries and commodities in 2011. In both cases, the surge of international food prices has been variously transmitted to domestic markets, and combined in different ways with national and local factors affecting prices—which often remain greater determinants of volatility, particularly in poorly market-integrated rural areas.

While an analysis of the many factors behind the price hikes is beyond the scope of this short chapter, two of these are worth emphasizing because they are important aspects of the new environment facing policymakers tackling rural poverty. These are a growing imbalance between demand and supply of food and other agricultural products, and the (possibly more frequent) occurrence of supply shocks linked to extreme weather events. Other factors have been behind the spikes—for example, dollar depreciation, decline in global cereal stocks, rising oil prices and growing biofuel production, misguided trade policies and the financialization of commodities. Some of these may also affect the capacity of agriculture to be a driver of inclusive economic growth in the near future. However, the first two factors are part of a longer-term change in the environment for agriculture that has greater implications for the ability of this sector to contribute to rural poverty eradication. These implications need to be coherently addressed by policies and strategies to foster poverty-eradicating rural growth. At a minimum, they signal the need to focus policy initiatives on harnessing opportunities for smallholder producers to contribute to rebalancing food supply and demand, and for other rural poor people to find entrepreneurial and decent job opportunities in other approaches to rebalancing food supply and demand not centred on smallholder agriculture. Moreover, this signals that agriculture needs

not only to produce more (and to lose less post-harvest), but also to be far better adapted to a changing environment.

Whatever the underlying opportunities, the balance of the impact of the price hikes on poverty and hunger has been negative. During the 2007-2008 crisis, it was calculated that about 105 million people had been added to the fold of the very poor (Ivanic and Martin, 2008). By 2009, the Food and Agriculture Organization of the United Nations (FAO) estimated that as many as 115 million had been added to the fold of the hungry, raising their total number above one billion (Food and Agriculture Organization of the United Nations and World Food Programme, 2009). Though the current price hike has not ended, some calculations of its poverty effects have been made. The World Bank places the net figure of people that have fallen below the extreme poverty line as a result of the price spike between mid- and end-2010 around 44 million people—resulting from about 67.7 million falling into poverty and 24 million rising above the poverty line, based on extrapolations of data from 40 countries (Ivanic, Martin and Zaman, 2011). During both crises, poor households have resorted to consumption of less, or less nutritious food. The result has been increased hunger and malnutrition, often affecting particularly poor women and children.

While some income-related effects of the price spike may be short term, they show the precariousness of livelihoods just above the poverty line in a context of food price volatility. Traditionally, crossing the line upwards tends to be a slow process, while crossing it downwards can occur suddenly, as a result of a shock (e.g., a harvest failure, an extreme weather event, etc.) (International Fund for Agricultural Development, 2010). What the food price crises suggest is that sudden increases in food prices can also be shocks with impoverishing effects for rural households, especially if the increases are large and protracted. While the direct income effect may be short term, the impact of household assets, food security and malnutrition may have long-lasting consequences for the income generating capacity of entire households, and the growth prospects of entire communities (World Bank, 2006).

When it comes to poor rural people with livelihoods based on agriculture, it may be expected that they would generally benefit from higher food prices. After all, small farmers across the developing world have suffered the impact of artificially low food prices for decades. However, most poor farmers in the developing world are net food buyers—either because they sell less food than they buy, or because they make less money selling food than they make buying it. Moving from net food buyer to net food seller may thus appear to be a precondition for farmers to benefit from higher food prices, including perhaps new price spikes in the coming years. Indeed, being net sellers or buyers is the main discriminating factor between losers and winners from the recent price surges, according to the recent World Bank study (Ivanic, Martin and Zaman, 2011).

Unfortunately, the reasons why most small farmers are net food buyers are often not simple, nor easy to address. They have to do with low land, labour or

capital productivity. They may have to do with poor access to financial services, inhibiting investment or forcing farmers to sell their surplus when market prices are unfavourable. Other reasons have to do with poor storage capacity, prompting early sales or leading to post-harvest losses. Very often, they include limited and costly access to markets due to poor rural infrastructure and poor governance of existing infrastructure. Weak market power is also a critical impediment. All these factors need to be addressed to allow poor smallholders to become net food sellers, where they have potential and opportunities to do so. At the same time, the limited ability of agriculture to sustain the livelihoods of all those who currently rely on it makes the shift to net food seller status an unfeasible proposition for all of today's poor farmers. Hence, of critical importance is to ensure that those who cannot become net food sellers have sufficient income to be "solvent" buyers. Again, part of the solution to this challenge may also come from ensuring that good entrepreneurial and decent job opportunities are created for these people in the effort to rebalance food demand and supply, whether or not centred on smallholder agriculture.

As observed during the recent food price crises, price volatility hinders a proper response from small farmers (including net food sellers) to price increases, hurting them both as consumers and as producers. Price unpredictability makes investment to meet growing market demand and higher prices too risky for many farmers, especially when they have a limited asset base, little access to risk-management tools through financial markets or other, and limited market information. Where rural infrastructure and services are inadequate, the risks of increased investment are even greater (World Bank, 2011). On the one hand, increasing market integration for small farmers and rural workers is thus required to seize new opportunities around agriculture. On the other hand, this entails being more exposed to market volatility risks. These need to be mitigated and better managed to allow rural women and men to work their way out of poverty through agricultural markets (Delgado and others, 2011). This is not only important for fostering poverty-reducing rural growth, but also for increasing food availability on domestic markets, helping to reduce food insecurity and contain price spikes (Prato and Alpha, 2011).

In short, at present, rural people working in agriculture or in ancillary rural sectors hold one important key to the solution to food insecurity and to supply shocks that may entrench poverty, thanks to their critical role in food production (Food and Agriculture Organization of the United Nations and others, 2011). However, both price volatility and poverty, combined with other factors, hold them back from playing this role as effectively as needed. Addressing this situation requires focusing more policy efforts and resources on agriculture, as well as on rural areas and people, ensuring that not only smallholders benefit from efforts to rebalance food demand and supply, but also others working in or around agriculture. While much of what is needed is well known to policymakers, some additional pointers can be derived from policy responses to the price spikes—although it is early to assess the poverty impact of individual responses.

A few policy lessons from responses to the crises

The 2007-2008 crisis prompted a variety of policy and investment initiatives for food security and nutrition. International responses have, among other things, included initiatives for greater donor, donor-country and policy coordination to achieve food security, the development of new mechanisms to sustain larger donor investments in food security in developing countries. Regional initiatives have also emerged or been re-energized by the food price crisis—the latter applying in particular to the Comprehensive Africa Agriculture Development Programme (CAADP) process in Africa. At the national level, more countries have been prioritizing food security in their policies and investments. Many have also resorted to short-term safety net initiatives, or strengthened existing social protection programmes. Though urban populations have typically been more easily reached by such programmes, the crisis showed that rural poor people need food security-sensitive safety net (and broader social protection) coverage just as much as urban people do (Food and Agriculture Organization of the United Nations, 2010b). In general, policy responses (especially in 2007-2008) have aimed to reduce the immediate impact of each food price crisis, but many have also aimed to tackle the underlying imbalance between food supply and demand—where supply is not simply the result of production but of market availability and accessibility, and demand includes the ability of poor people to purchase the food they need (Viatte and others, 2009). Indeed, perhaps the key policy lesson of the crises is that both sets of responses need to be coherently integrated into policy approaches to rural poverty eradication centred on agriculture in a context of price volatility.

Support to agricultural investment has been part of both short- and longer-term responses. In some countries, public investments or incentives to private investments have been driven by a search for food self-sufficiency (e.g., this has been the case in some Asian countries such as China, Indonesia and the Philippines, as well as in some Latin American countries, some countries in sub-Saharan Africa, such as Senegal, and some capital-rich and farmland-poor countries in the Gulf, for instance). Large-scale private or public-private investments in land for agriculture have also been driven by a combination of a focus on increasing production and maximizing profit. However, increasing large-scale investment in agriculture has evidenced important policy gaps in many countries. These include weak policies and institutions protecting the land and water entitlements of poor rural women and men, weak business and contract laws, and inadequate governance and accountability mechanisms for allowing poor rural people to articulate their interests. Some international initiatives of policy relevance for rural poverty eradication have emerged in this context—for instance, around the Voluntary Guidelines on Responsible Governance of Tenure of Land, Fisheries and Forests and the FAO, IFAD, the United Nations Conference on Trade and Development (UNCTAD) and World Bank Principles for Responsible Investment in Agriculture. Other initiatives concern the search for inclusive business models

in agricultural supply chains. One important lesson from the price hikes is that this is a critical area of policy work for rural poverty eradication around agriculture. In particular, it is of paramount importance to focus policy attention on how to harness private investments in agriculture so as to bring new resources and capacity to rural areas to benefit smallholders and rural workers, with due attention to protecting the rights and resources of poor rural households (Cotula and Leonard, 2010).

Another type of policy response to the crises concerns short-term support to food production through measures to boost small farmers' access to seeds, energy and fertilizers. In many cases, countries have resorted to non-market-based measures to achieve this, granting privilege to short-term concerns over considerations of sustainable local production capacity. For instance, access to fertilizer has been boosted through subsidy or free distribution programmes, sometimes with impressive short-term results. Some Governments have resorted to policy measures introducing or scaling up subsidies to use electricity or fuel for irrigation. India, for instance, kept in place subsidies on fertilizers, irrigation *and* power during the 2007-2008 price spike. While the short-term impact of such measures may be positive, their sustainability given recurrent price volatility and environmental scarcities is debatable.

A more limited number of Governments have taken a longer-term perspective. They have undertaken to strengthen their national seed industries through supporting seed production, building up improved seed buffer stocks, and strengthening seed quality control and related institutional capacity. Some have strengthened or put in place new farmer-based seed multiplication initiatives to maximize participation of smallholders. In some cases, there have been initiatives geared towards supporting private sector agro-dealers to better reach out to smallholders (Cotula and Leonard, 2010). In other countries, the crises have prompted new investments in rural infrastructure (storage, irrigation, energy). In a limited number of countries, multi-stakeholder platforms have been set up to bring public and private sector representatives together to develop investment plans to boost agricultural supply, reduce poverty, and enhance food and nutrition security (e.g., through growth corridors). All such measures are part of what is needed to put in place better functioning markets for agriculture, which can contribute to inclusive, poverty-reducing rural growth. As such, they are likely to be an important part of policy agendas aiming to harness changes in global agricultural markets to progress towards eradicating rural poverty.

The importance of investing in more sustainable and resilient agriculture to stabilize supply and avoid food price crises has also become evident from the price spikes, and some Governments have boosted their commitments in areas such as climate adaptation and disaster risk reduction in agriculture and in rural areas. Against the background of climate change, weather shocks are expected to become more frequent in many parts of the world. The implications for rural poverty are multifold. Severe weather events may disrupt infrastructure and markets, undermine

livelihoods and destroy or damage assets. They may undermine agricultural supply by affecting production and by making transportation from surplus to deficit areas more difficult. The poverty implications can be both immediate and long-lasting. Making rural livelihoods less vulnerable to such shocks is a priority for poverty eradication going forward. When it comes to agriculture, this calls for an agenda of more sustainable agricultural intensification, climate change adaptation and risk mitigation, as articulated in many recent publications (International Fund for Agricultural Development, 2010; International Assessment of Agricultural Knowledge, Science and Technology for Development, 2009; Foresight, 2011). Effective policy work in this area needs to engage agriculture ministries with climate and environmental offices, ministries of finance, and others. As detailed in the IFAD *Rural Poverty Report 2011*, ministries of education also have a critical role, as sustainability and resilience in agriculture and in rural livelihoods depend on strengthening the capabilities of small farmers and poor rural people— young people in particular—to deal with challenging environmental and market circumstances (International Fund for Agricultural Development, 2010).

Another important set of policy measures through which Governments have sought to address the price crises concerns trade and price policies. These have included trade restrictions, tariff reductions and trade subsidies, as well as price setting, legislation and measures to discourage hoarding or to encourage market operators to mitigate price swings, and public or public–private food marketing.²⁷ This is a critical area for policy attention going forward because it is one where short-term conflict of interests between different social groups easily emerge, and which need to be well managed to harness the potential of agriculture to foster inclusive growth. For instance, often designed to pacify urban consumers, trade and market measures that aim to depress or fix prices can benefit poor consumers in the short term. However, they can undermine prospects for domestic food security and for poverty reduction through agriculture. Increasingly, it is important to achieve a balance between shielding poor consumers (rural and urban) and enabling food producers to seize new opportunities to overcome poverty.

Rather than trade restrictions and price-depressing policies, policy initiatives that can help achieve such a balance include safety net programmes that reduce people’s vulnerabilities rather than altering market signals. There is evidence that such programmes, if well targeted and managed, can have significant impact on

27 For instance, a 2009 FAO review of country responses to the 2007–2008 crisis found that, out of 81 sampled countries, 43 had resorted to reduction of tariffs or custom fees, while 35 had resorted to public sales from public stocks or imports. The review found that such responses had, in many cases, positive short-term impacts in terms of minimizing the poverty and food insecurity impacts of the price hike, but they also posed problems in terms of economic or financial sustainability. About 25 sampled countries resorted to export bans, and 21 countries enforced price controls, either through single-handed government action or through agreements with the private sector (e.g., in Burkina Faso, Mexico and elsewhere) to prevent local price hikes. See Demeke, Pangrazio and Maetz (2009).

reducing income inequalities—for instance, this has been the case of conditional cash transfers in countries like Brazil, Chile and Mexico. A variety of safety net initiatives have been undertaken in response to the price crises, with a focus on improved access to food and nutrition.²⁸ In some cases, these have built on pre-existing programmes. Where they have done so, safety net interventions have often been rather effective in buffering the effect of the 2007-2008 price crisis, demonstrating the importance of maintaining well-targeted safety net programmes that can be scaled up or adjusted quickly during crisis periods. This was, for instance, the experience of the conditional cash transfer programme *Oportunidades* in Mexico. However, in the developing world as a whole, the coverage of safety net programmes is very low, particularly in countries with limited fiscal resources. How to develop sustainable financial bases for such programmes should be a major issue on the agenda of policymakers in the near term.

In addition, the recent crises have demonstrated the importance of putting rural areas and rural people high on the policy agenda when it comes to social protection. They have demonstrated this not only for food security and nutrition reasons, but also in terms of enabling people to overcome poverty or to preserve their livelihoods once they have moved above the poverty line. IFAD surveys among smallholders in various countries in 2009 and in 2011 show that smallholder households tend to respond to price hikes not only by changing their nutrition patterns and cutting down on welfare expenditures, but also by altering their production patterns—taking less risks, often producing less for the market and more for their own consumption, selling productive assets, and so forth. Such coping mechanisms can entrench poverty among small farmers, and drive into poverty those who live just above the poverty line. On the other hand, where smallholder households are covered by adequate safety net programmes (as in the cases of many rural households in Brazil, Mexico and elsewhere), this is less likely to happen.

Going forward, given an increasingly unstable natural and market environment, investing in adequate safety net programmes targeted to include smallholder households is a necessity in many countries. However, again, to combine short-term food security and nutrition achievements with inclusive, poverty-reducing growth, it is critical to balance well the interests of different constituencies in such programmes. For farmers, incentives to produce more and better food for the market, and to do so on more sustainable grounds, need to be in focus in the context of safety net programmes targeting food insecurity and under- (or mal-)nutrition. For policymakers, models to draw from are those that combine support to food supply capacity with support to solvent demand among poor people. Programmes that source from small farmers for school-feeding and

28 For instance, Demeke, Pangrazio and Maetz (2009) report that 23 countries out of 81 sampled used cash transfers, 19 used direct food assistance, and 16 used a variety of measures to increase the disposable income of poor people, to dampen the effect of the 2008 price spike on vulnerable people.

other social programmes, such as those implemented on a large scale in Brazil and elsewhere in recent years, are a good example. Other lessons can be drawn from initiatives combining production-focused safety nets (e.g., fertilizer or seed vouchers for farmers), or building or restoring rural infrastructure, with food and nutrition assistance.

Finally, one lesson from the crises is the need to strengthen the risk management capacity of small farmers. Four areas appear to deserve particular policy attention in this regard. First, an enabling policy environment is needed for financial institutions to develop and reach out to rural poor women and men with a range of products (savings, credit, insurance, remittance transfer) and inclusive modalities, and for them to develop new products suited to meeting new challenges, including price volatility and weather shocks. Second, securing farmers' natural resource entitlements so they can benefit at lower risk from opportunities to take part in agriculture-led growth requires improved land and water policies and strengthened capacity for implementation and for conflict management. Third, enabling policies are needed to foster R&D and innovation agendas for more risk- and shock-resilient production, and post-harvest processing and marketing, targeting both women and men farmers to play more effective roles in addressing supply gaps. Finally, organization is critical for risk-spreading and risk management among farmers, and it is also very important to advance the rights of rural workers. However, building strong rural organizations requires enabling policies concerning group formation and registration, cooperative laws, decent work legislation, and so forth.

In sum, policy responses to the price spikes have been diverse, but yield some important common lessons particularly as concerns the need to balance short- and longer-term considerations, the interests of poor urban consumers and rural producers and workers, and the importance of reducing and better managing risk. The needed policy agendas should, however, be developed to respond to different contexts and the needs and expectations of different constituencies. The common thread is the possibility of using policy tools to seize opportunities for inclusive rural growth linked directly or indirectly to agriculture in all those areas where the latter has significant potential to help address the underlying causes of price volatility.

Conclusions

The food price crises have highlighted the vulnerability of poor rural people's livelihoods to price volatility and shocks, and placed food security and nutrition high on the agenda of policymakers tackling rural poverty. They have also highlighted the inadequacy of global and domestic food systems that keep the majority of small food producers and rural workers from living up to their

potential to contribute to inclusive growth and a rebalancing of food supply and demand through sustainable and resilient agriculture.

It is generally agreed that responding to the price crises requires a combination of short- and long-term actions—the twin-track approach well detailed in the United Nations Comprehensive Framework for Action, among others—and that these need to focus on support to smallholder agriculture, rural areas and rural people. As noted, this requires a broad set of policy actions, spanning agricultural production, agricultural markets and trade, improving the environment of rural areas in terms of infrastructure and services, putting in place adequate social protection and safety net programmes, and reducing the risks involved in working in agriculture and in rural areas.

There is no blueprint to follow in terms of specific policies or their sequencing. However, it is critical everywhere that poor rural people be supported in their ability to overcome poverty by seizing new opportunities at reduced risk. Appropriate policy initiatives very much need to focus on strengthening poor rural people's capabilities as well as on facilitating the creation of opportunities. Whatever the nature of specific initiatives, a change of mindset is also in order, to see poor rural people not only as victims of the price crises but also as part of the solution to the global imbalances that underlie them, and which may hold new opportunities for inclusive rural growth and poverty eradication.

References

- Carr, Marilyn, and Maria Hartl (2010). *Lightening the load. Labour saving technologies and practices for rural women*. Warwickshire: International Fund for Agricultural Development and Practical Action Publishing Ltd.
- Chen, Shaohua, and Martin Ravallion (2007). Absolute poverty measures for the developing world, 1981-2004. Policy Research Working Paper, Series No. 4211. Washington, D.C: World Bank.
- Christiaensen, Luc, Lionel Demery and Jesper Kuhl (2010). The (evolving) role of agriculture in poverty reduction: An empirical perspective. Working Paper No. 2010/36. Helsinki: United Nations University–World Institute for Development Economics Research.
- Cotula, Lorenzo, and Rebeca Leonard (eds.) (2010). Alternatives to land acquisitions: Agricultural investment and collaborative business models. Highlights from an international lesson-sharing workshop, Maputo, 17-18 March. London/Bern/Rome/Maputo: International Institute for Environment and Development, Swiss Agency for Development and Cooperation, International Fund for Agricultural Development and Centro Terra Viva.
- Delgado, Christopher, Robert Townsend, Iride Ceccacci, Yurie Tanimichi Hoberg, Saswati Bora, Will Martin, Don Mitchell, Don Larson, Kym Anderson and Hassan Zaman (2011). Food security: The need for multilateral action, in *Postcrisis Growth and Development: A Development Agenda for the G-20*, Shahrokh Fardoust, Yongbeom Kim and Claudia Paz Sepúlveda (eds.). Washington, D.C.: World Bank.
- Demeke, Mulat, Guendalina Pangrazio and Materne Maetz (2009). Country responses to the food security crisis: Nature and preliminary implications of the policies pursued. Rome: Food and Agriculture Organization of the United Nations.
- Fan, Shenggen, and Mark Rosegrant (2008). Investing in agriculture to overcome the world food crisis and reduce poverty and hunger. IFPRI Policy Brief No. 3 . Washington, D.C.: International Food Policy Research Institute.
- Food and Agriculture Organization of the United Nations (2009). How to feed the world in 2050. Papers prepared for the FAO High-Level Expert Forum on Feeding the World in 2050, Rome, 12-13 October 2009.
- _____ (2010a). *State of food and agriculture 2010-11. Women in agriculture: closing the gender gap for development*. Rome: FAO.
- _____ (2010b). FAO's Initiative on Soaring Food Prices: Guide for Policy and Programmatic Actions at Country Level to Address High Food Prices. Rome: FAO.
- Food and Agriculture Organization of the United Nations, International Fund for

Agriculture and Development, International Monetary Fund, Organization for Economic Cooperation and Development, United Nations Conference on Trade and Development, World Food Programme, World Bank, World Trade Organization, International Food Policy Research Institute and the United Nations High-Level Task Force on the Global Food Security Crisis (2011). *Price Volatility in Food and Agricultural Markets: Policy Responses. A Policy Report to the G20, including contributions by FAO, IFAD, OECD, UNCTAD WFP, the World Bank, the WTO, IFPRI and the UNHLTF.* 2 June.

Food and Agriculture Organization of the United Nations and the World Food Programme (2009). *The state of food insecurity in the world. Economic crises: impacts and lessons learned.* Rome: FAO.

Foresight (2011). *The future of food and farming: Challenges and choices for global sustainability, final project report.* London: The Government Office for Science.

Hazell, Peter, Colin Poulton, Steve Wiggins and Andrew Dorward (2007). *The future of small farms for poverty reduction and growth. 2020 Discussion Paper 42.* Washington, D.C.: International Food Policy Research Institute.

Himanshu, Peter Lanjouw, Abhiroop Mukhopadhyay and Rinku Murgai (2010). *Non-farm diversification and rural poverty decline: A perspective from Indian sample survey and village study data. A paper prepared for the World Bank-SPIA-UC Berkeley Conference Agriculture for Development—Revisited, UC Berkeley 1 and 2 October 2010.*

International Fund for Agricultural Development (2010). *Rural Poverty Report 2011: New realities, new challenges: new opportunities for tomorrow's generation.* Rome: IFAD.

_____ (2011). *IFAD Strategic Framework 2011-2015.* [Rome](#): IFAD.

International Assessment of Agricultural Knowledge, Science and Technology for Development (IAASTD) (2009). *Agriculture at a Crossroads, Global Report.* United Nations Development Programme, United Nations Environment Programme, United Nations Educational Scientific and Cultural Organization, World Bank, World Health Organization and Global Environment Facility. Washington, D.C.: Island Press.

Ivanic, Maros, and Will Martin (2008). *Implications of higher global food prices for poverty in low-income countries. Agricultural Economics, vol.39, supplement, pp. 405-416.*

_____ and Hassan Zaman. (2011). *Estimating the short-run poverty impacts of the 2010-11 surge in food prices. Policy Research Working Paper No. 5633.* Washington, D.C.: World Bank, April.

Prato, Bettina (2009). *How can small farmers and poor rural people actively*

participate in policy processes? Unpublished background paper for the International Fund for Agriculture Development, Rural Poverty Report 2011, Rome, IFAD.

_____, and A. Alpha (2011). Mitigating and better managing food price volatility—some of the implications for small farmers and rural poor people. Unpublished paper, Office of Strategy and Knowledge Management, IFAD. Rome.

Spielman, David J., and Rajul Pandhya-Lorch (eds.) (2009). *Millions Fed: Proven successes in agricultural development*. Washington, D.C.: International Food Policy Research Institute.

Swinnen, Jo, Miet Maertens and Anneleen Vandeplas (2010). Governance and smallholder farmer competitiveness in high value food chains. A paper prepared for the World Bank-SPIA–UC Berkeley conference, Agriculture for Development—Revisited, UC Berkeley, 1 and 2 October 2010.

United Nations Development Programme (2009). Energy in national decentralization policies. A review focusing on Least Developed Countries and sub-Saharan Africa. New York: United Nations.

United Nations Educational, Scientific and Cultural Organization (2010). *Education for all global monitoring report: Reaching the marginalized*. Oxford/Paris: Oxford University Press and UNESCO Publishing.

Viatte, Gérard, Jacques De Graaf, Mulat Demeke, Takashi Takahatake and Maria Rey de Arce (2009). Responding to the food crisis: synthesis of medium-term measures proposed in inter-agency assessments. Rome: Food and Agriculture Organization of the United Nations.

Vorley, Bill, and Felicity Proctor (eds.) (2008). *Inclusive Business in Agrifood Markets: Evidence and Action A report based on proceedings of an international conference held in Beijing, March 5–6, 2008*. London: International Institute for Environment and Development.

World Bank (2006). *Repositioning nutrition as central to development*. A strategy for large-scale action. Washington, D.C.: World Bank.

World Bank (2011). Responding to global food price volatility and its impact on food security. Paper presented to the Development Committee Meeting of 16 April 2011. Washington, D.C.: International Monetary Fund and World Bank.

Chapter 5

Sustaining effective anti-poverty programmes beyond transformation: challenges and way forward

JULIAN MAY

Introduction

In January 1961, the United Nations declared its first “decade of development” focusing on increasing the growth rate of aggregate national income in developing countries while recognizing the need to benefit the poorer sections of the population. Four decades later, on 8 September 2000, following a jointly produced report entitled *A Better World For All: Progress towards the international development goals*—published by the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the United Nations and the World Bank—189 countries committed themselves to the Millennium Declaration and, subsequently, to a set of measurable goals and targets proposed for attainment by 2015, the Millennium Development Goals (MDGs). Notwithstanding these sentiments, at the beginning of the twenty-first century, high levels of poverty persist in almost all regions of the world, and especially in sub-Saharan Africa. While the share of the global population categorized as being poor may have declined during the 1990s, the actual number of poor people continued to rise, and had approached 1.2 billion by 2010, the most recent baseline available. The poor prospects of achieving the MDG goal of halving world poverty for sub-Saharan Africa are noteworthy. While the poverty headcount in the region has declined from 51.5 per cent in 1981 to 48.5 per cent in 2010, continued progress could see sub-Saharan Africa’s extreme poverty rate drop to 42.3 per cent in 2015 and to 23.6 per cent in 2030 (World Bank and International Monetary Fund, 2013; Chandy, Ledlie and Penciakova, 2013).

The persistence of poverty is especially startling in the context of South

Africa. On the eve of South Africa's transition to democracy, the country was described by international development agencies as an upper-middle-income country with a per capita income in 1991 similar to that of Botswana, Brazil, Malaysia or Mauritius (United Nations Development Programme, 2003). However, it was estimated that over half of South Africans were poor, with almost 2.5 million people thought to be suffering from malnutrition (Carter and May, 1999). Worryingly, despite the priority given to reducing poverty and inequality in 1994 by the incoming Government, most studies have revealed that levels of poverty continued to increase in South Africa between 1993 and 2000 (Özler, 2007; Leibbrant and others, 2010; Statistics South Africa, 2001; van der Berg and others, 2005). The result has been an increase in the number of people categorized as poor between 1995 and 2000 by some 2 million, irrespective of whether the poverty line used is the well-known \$1 or \$2 per day, corrected for purchasing power parity (PPP), or any of the various national poverty lines that have been proposed. Despite being one of the 30 largest economies in the world in terms of gross domestic product (GDP), and after almost two decades of transformation from a pariah State grounded on institutionalized discrimination to the democratic host of international sporting events, poverty remains a critical issue in South Africa. Indeed, with a population of some 16 million poor people as reported by the United Nations Development Programme (UNDP), South Africa is home to the sixteenth largest number of poor people among the 67 countries for which comparative data are provided, and to the fifth largest number in sub-Saharan Africa (United Nations Development Programme, 2009). This, coupled with the gloomy predictions for poverty reduction in the region, provides the motivation for understanding poverty dynamics in South Africa as an example of the problems facing any society in sustaining poverty reduction after political transformation and economic reforms.

Assessing the scale of deprivation in post-apartheid South Africa

Although attempts to assess the scale of poverty in South Africa have a long history, as with most other aspects of the country, the data and measures used are inconsistent and often incomplete and reflect a legacy of 40 years of segregation and dispossession. In one of the earliest studies, using sample surveys conducted in 1959, some 50 to 75 per cent of the African population of urban South Africa were thought to be unable to afford a diet and life-style determined to be minimally adequate (de Gruchy, 1960). During the mid 1970s, it was estimated that between 68 per cent and 77 per cent of all African families lay below a national poverty line (the minimum living level), suggesting a surge in poverty levels during the era of "grand apartheid" (Study Project of Christianity in Apartheid Society, 1972). By the mid 1980s, estimates for the rural areas designated for African

settlement lay at about 75 per cent, and at 43 per cent for the total population (Simkins, 1984; Natrass and May, 1986). Data collected from the first nationally representative sample survey undertaken in 1993 revealed that just over half (52 per cent) of all African households in rural areas were poor as their scaled per capita expenditure fell below a commonly used poverty line derived from the Household Subsistence Level (HSL) (Carter and May, 1999). Using a poverty line of R(2000) 322 per person per month, Özler (2007) reports that some 58 per cent of South Africa's population can be categorized as being poor in 1995, a situation that had not changed by 2000, although there had been a marginal decline in the poverty incidence of Africans, from 68 per cent in 1995 to 67 per cent.

An important point that can easily be overlooked is that whatever line, data or approach is used, the actual number of poor people increased in the immediate post-apartheid era. This is illustrated by a recent OECD report on poverty trends in the post-apartheid era (Leibbrandt and others, 2010). While the incidence of poverty modestly declined from 56 per cent in 1993 to 54 per cent in 2008, the population increased by an estimated 8.5 million people, and as a result, the number living below the poverty threshold increased by 3.8 million. The changing nature of South African poverty is also evident from the OECD report, with the urban population increasing by 9.5 million, swelling the numbers of urban poor by 4.7 million, while the number of rural poor declined by 770,000. This rise in urban poverty may be a result of migration by the poor from rural to urban areas.

Although the discussion thus far has focused on money-metric poverty, poverty reduction programmes must take account of other forms of deprivation. Physical poverty reflects inadequate access to essential services and is largely derived from a basic needs approach to development. This recognizes that changes in the quality and availability of services are not captured by changes that measure income alone. Using large sample surveys for South Africa, Bhorat, Naidoo and Westhuizen (2006) report improvements in housing, access to water, access to electricity and access to toilets between 1993 and 2004, with access to electricity for lighting increasing from 52 per cent of households to 80 per cent, and access to piped water increasing from 59 per cent to 68 per cent of households, a result that is confirmed by the relatively positive position of South Africa in a report released in 2010 by the Oxford Poverty and Human Development Initiative on multidimensional poverty (Alkire and Santos, 2010). However, in addition to resources to keep up with population growth, migration into urban areas and further household fragmentation, an estimated R110 billion will still need to be found to eliminate the remaining backlogs in basic service delivery (National Treasury, 2008, p. 143).

In summary then, although South Africa does not yet have an official poverty line, the poverty profile of the country is comparatively well established. The highest incidence of absolute poverty is to be found in South Africa's rural communities, especially in the former "homelands" in which poor infrastructure, a weak asset base, repeated shocks and limited economic opportunities create

poverty traps from which it is difficult to escape. This in turn leads to the migration by those who can to the urban centres of South Africa, and to a steady increase in the numbers of poor in these areas. Urban poverty is thus emerging as an important dimension of the poverty problem in South Africa, while rural communities fall further behind. At the same time, South Africa is characterized by other forms of poverty that include the exclusion of a substantial portion of the population from the economic mainstream. This is particularly noteworthy among young school-leavers who find it difficult to obtain employment in the face of the very high levels of unemployment and the limited prospects for a substantial expansion in the formal labour market which could absorb the numbers of young people who enter the market each year. Even among those who are already employed, poor work conditions and informality result in low wages and insecurity.

The final component of the South African poverty profile that warrants comment relates to the quality of life that many of the poor face. Poor health is one aspect of this, relating to the numbers of people living with HIV/AIDS as well as arising from poor nourishment, crowded and unsanitary conditions in urban slums and lifestyle diseases such as diabetes, heart diseases, depression and obesity. Other issues relate to the different aspects of child poverty, the situation of older people who are often expected to resume caring for children and ill people, and to prejudice and discrimination, including xenophobia.

Anti-poverty strategy in post-apartheid South Africa

The analysis just presented means that the South Africa poverty profile is complex, as are the causes and outcomes of deprivation. To be successful, policies will have to be similarly nuanced, with clear target groups in mind and appropriately inserted into the equally complex legacy of apartheid, as well as the complex system of government that South Africa has adopted. Anti-poverty strategies have been a consistent theme of successive South African Governments since 1994. Indeed, the Reconstruction and Development Programme (RDP) prepared in 1993 as the incoming Government's manifesto, singles out the reduction of poverty in all its dimensions as the central concern for the post-apartheid era. However, the macroeconomic environment has obviously conditioned the economic possibilities for achieving this. During the 1960s, the South African economy grew at some 6 per cent per annum, while total employment grew by nearly 3 per cent per annum, in line with population growth. By the late 1980s, the real economy was shrinking, as was formal sector employment. This trend was briefly reversed after the country's first democratic elections, with sustained growth throughout 1995. By the middle of 1998, economic growth fell to less than 0.5 per cent per annum. The subsequent period saw a more favourable trend, with positive, if at times weak, per capita growth peaking at 4.5 per cent in 2004 owing to both the rate of expansion of the economy and slowing population growth.

The South African Government's response to these periods of poor economic performance was constrained both by international economic trends as well as by inherited fiscal realities. The apartheid Government left a total public debt of R190 billion, of which foreign debt amounted to some R5 billion (South African Reserve Bank, 1996). Between 1993 and 1998, some 6.7 per cent of GDP, and 24 per cent of the budget, was annually absorbed by interest on this debt. Further, in line with the conservative macroeconomic stance taken by the Growth Employment and Redistribution plan (GEAR), the Government contained growth in public expenditure and reduced its public sector borrowing requirement from 9.3 per cent of GDP in 1993/94 to just 0.3 per cent in 2005/06, and a modest surplus in 2006/07 and 2007/08.

Weak economic growth resulted in declining formal employment, which fell by 12 per cent, or some 642,000 jobs, between 1993 and mid-1998 (Central Statistical Service, 1994; Statistics South Africa, 1999). Job losses were highest in those sectors that employ unskilled labour, with the manufacturing sector suffering a 6 per cent loss in jobs between 1993 and 1998, compared with 21 per cent in construction and 27 per cent in mining (Central Statistical Service, 1994; Statistics South Africa, 1999, 2001). This was followed by a period of job creation, with the number of formally employed increasing by almost 2.5 million between 1998 and 2004, half of which took place in the formal non-agricultural sector (Statistics South Africa, 2005). Nonetheless, unemployment has increased for much of the post-apartheid period. According to a narrow definition of unemployment, 20.0 per cent of the economically active population were unemployed in 1994, climbing to 25.2 per cent in 1998 before peaking at 30.4 per cent in 2002 and eventually falling to 24.4 per cent in 2008 (Leibbrandt and others, 2010).

Responding to these challenges during the period that followed the first democratic elections, the South African Government's orientation towards addressing the problems of poverty and inequality underwent some marked shifts, in language and emphases, if not in substance. The 1996 closure of the Office of the Reconstruction and Development Programme signalled, to some at least, a symbolic reduction in the priority given to improving the access of the majority of South Africans to adequate shelter, sanitation and education. While programmes to provide such social services continue to reside within relevant ministries, in this period, the dominant acronym in South African public policy debate shifted from RDP to GEAR, the label attached to the Government's macroeconomic stabilization and structural adjustment framework. Justifying the fiscally conservative stance adopted by GEAR, the South African Government pointed to the need for economic adjustment, improved revenue collection and the maintenance of investor confidence. During this period, South Africa's Minister of Finance lauded this decision, arguing that recent stronger growth in GDP allowed for greater spending by all spheres of government, and as a result, from 2004 to 2006, the Government embarked on a relatively expansionary phase, unveiling the Accelerated and Shared Growth Initiative—South Africa (Office

of the President of the Republic of South Africa, 2004). As a result, the amount allocated in the national budget also increased steadily between the periods 2003-2004 and 2008-2009, although the fiscally cautious approach of the Government to borrowing remained. Budgeted expenditure increased at an average of 14.8 per cent per annum compared with national revenue, which increased by 18.7 per cent per annum. Overall, the revenue available for the total budget has grown fivefold since 1994-1995, to R559.8 billion in 2008-2009, with a decrease in the budget share allocated to military expenditures. However, the share allocated to social services increased from 54 per cent in 1994 to 59.2 per cent in 2003-2004 (Ajam and Aron, 2007). Of this allocation, education received the largest share, followed by health, social security and housing.

Decentralization has been implicit in many of the policies and strategies adopted for poverty reduction. The South African Constitution adopted in 1996 introduced an elaborate system of cooperative governance and replaced the previously centralized national Government with three separate, interdependent and interrelated “spheres” of government: a national Government, nine provincial governments and 284 municipal governments who are expected to work within a system of “cooperative governance”. The devolution of authority adopted after 1994 can be distinguished from other forms of decentralization in which some of the activities of national Government are simply delegated to lower tiers of government, to be revoked should the central authority deem otherwise. Instead, there is a vertical division of authority, assigning each sphere its own powers, functions and responsibilities, while limiting the extent to which each can intervene in the decisions of the other spheres (Pimstone, 1998). However since responsibility for revenue generation is unequally distributed, with the national Government having access to a much wider variety of tax instruments compared to other spheres, on average, between 2001 and 2004, 89 per cent of national revenue accrued to the national Government, while the share of provincial and municipal governments was 5 per cent and 6 per cent, respectively (Yemek, 2005).

Compared to the provincial governments, municipalities have greater powers to raise their own revenues through property and business taxes and to impose fees for services such as electricity, water and sewerage. As a result, municipalities obtain on average about 86 per cent of their income from their own revenue sources, with just 14 per cent of municipal budgets being derived from national and provincial transfers. To adjust for inequalities between municipalities and provinces in terms of their ability to generate revenue, the Division of Revenue Act (DoRA) provides for the annual allocation of national revenues to each of the three spheres of government. Through this mechanism, there has been a steady growth in transfers from the national Government to provincial and municipalities, which increased by 10 per cent to provinces and 13 per cent to municipalities between 2005 and 2007 (National Treasury, 2005). In 2008-2009, just over 50 per cent of the consolidated budget was allocated to the national departments, 42 per cent to the provinces and 7.7 per cent to municipalities (National Treasury, 2008).

This system of decentralized government is important, since the 2007 South Africa MDG report comments that Government's overarching policy to address MDG 1 (eradicate extreme poverty and hunger) is through the provision of a "social wage" package. This includes free clinic-based primary health care (PHC) for all, compulsory education for all those aged seven to thirteen years, and subsidies on housing, electricity, water, sanitation, refuse removal, transportation and so forth for those who qualify. Most of these programmes fall within the mandate of the subnational spheres of government.

The value of the social wage was estimated to be R88 billion in 2003 and it is evident that South Africa has achieved considerable success in terms of improvements to household access to most services (Office of the President of the Republic of South Africa, 2007a). In the case of piped water, some 15 million previously unserved people have been connected to a formal water supply since 1994, with 85 per cent of households reporting access in 2001, rising to 80 per cent by 2006 (National Treasury, 2008). Just 7 per cent of the population now live without access to an improved water source while 15 per cent still have a water supply that is less than the Government's target provision (Office of the President of the Republic of South Africa, 2007b). Nonetheless, considerable backlogs still exist for most of these services in terms of the unserved population, carrying a substantial burden in terms of the cost of delivery. In addition to keeping up with population growth, migration into urban areas and further household fragmentation, an additional R110 billion will need to be found if the remaining backlogs in basic service delivery are to be eliminated.

As a short-term measure to address poverty, social grants payments are especially important in South Africa, where there has been an increase in the number of beneficiaries in receipt of grants from 2.9 million in 1994 to 13.4 million people in April 2009 (Leibbrandt and others, 2010). Although the Old Age Pension (OAP) was established during the apartheid era, the introduction in 1998 of a Child Support Grant (CSG) for children younger than seven years is especially noteworthy. The coverage of this grant was expanded to older children in later years and now reaches 9.1 million children. Grant payments have risen from 2.9 per cent of GDP and now amount to 4.4 per cent, which is three times higher than the median spending of 1.4 per cent of GDP across developing and transition economies (Leibbrandt and others, 2010, p 53)

Another important component of the Government's short-term response to poverty reduction has been through the Extended Public Works (EPWP) which was introduced in 2004. By 2008, the EPWP had provided more than 1 million work opportunities with a wage bill of just less than R1 billion. The National Treasury (2008) believes that more can be done by local government, and has recommended that municipalities opt for more labour-intensive approaches to the delivery of services. A recent pilot initiative, the Community Works Programme, provides an employment safety net in selected areas.

Education is an important long-term strategy for poverty eradication and

despite the inequities of the apartheid era in terms of education, primary school enrolment has been consistently high. The South African Schools Act (1996) made educational attendance compulsory for all children aged 7 to 15, placing this responsibility on both parents and the State. Further, the 2005 Education Amendment introduced a School Fee Exemption policy in 2007 that exempts parents from paying fees according to a means test, while a no-fee policy establishes schools without fees. The Primary School Feeding Scheme Programme provides one meal a day to some 6 million primary school children in 18,000 schools.

The mid-term MDG report shows an improvement on the already favourable position of 2004 in which 95 per cent of children aged 7 to 13 years were in school. Enrolment is shown to be increasing for secondary schooling, while functional literacy is also improving. As a result, less than 1.5 per cent of youth aged 15-24 years have never attended school (Republic of South Africa, 2007). Furthermore, the teacher/learner ratio is below the government target of 40:1 in primary schools (Office of the President of the Republic of South Africa, 2007b). Indeed, South Africa has a relatively high adult literacy rate of 87.6 per cent of adults above the age of 15 years, and a combined primary, secondary and tertiary gross enrolment ratio of 76.8 per cent of eligible children (United Nations Development Programme, 2009). These statistics conceal the relatively poor performance of many children once enrolled in school.

A number of important policy changes have taken place in the post-apartheid period which should result in improved provision of health care and the reduction of child and maternal mortality and of some infectious diseases. These include the provision of free health care for pregnant women and children aged less than six years, shifting the method of health care from a curative to a preventative approach, as well as legislation concerning health insurance and the termination of pregnancy (Poggenpoel and Claasen, 2004). There has also been improvement in the provision of health services and facilities.

Despite these promising advances in the provision of health care, South Africa's controversial position on HIV/AIDS during the late 1990s and early 2000s has earned the country some notoriety. By the middle of 2006, 5.4 million people were estimated to be living with HIV in South Africa, the largest number of persons living with HIV infection in the world (Joint United Nations Programme on HIV/AIDS, 2008). While this is partly due to the country's overall population size, HIV prevalence is extremely high. Prevalence among women with HIV attending antenatal care increased from 7.6 per cent in 1994 to 30.2 per cent in 2005, while that for the population as a whole has increased from 8.5 per cent in 2001 to 11.1 per cent by 2007 (Office of the President of the Republic of South Africa, 2007b). Among adults aged 15-49 years, the HIV prevalence rate is estimated to have reached 21.5 per cent. There are signals that prevalence may be reducing, with Matjila and others (2008) reporting a decline in prevalence among women attending antenatal care to 29 per cent in 2006 and 28 per cent in 2007. However, premature adult mortality continues to increase with an estimated 345,000 South

Africans dying of AIDS in 2006, making the disease the leading cause of death in almost all South African provinces (Dorrington and others, 2006).

Recent events confirm better prospects, a less controversial stance on this issue and greater responsiveness to needs. The Comprehensive HIV and AIDS Programme provides support to approved prevention, treatment, care and support interventions including implementation of the Operational Plan for Comprehensive HIV and AIDS Care, Management and Treatment for South Africa (Streak, 2005). By 2007, this programme had 264,423 patients, almost double the number of patients treated one year earlier, but still accounting for only 5 per cent of those living with AIDS (National Treasury, 2007; Joint United Nations Programme on HIV/AIDS, 2008). HIV and AIDS thus remains an area of deep concern in terms of South African's prospects for poverty eradication, especially in terms of meeting health-related targets. For example, with 55 per cent of cases being co-infected with HIV, the incidence of reported tuberculosis (TB) cases has also increased by over 250 per cent since 1996, to reach 0.3 million cases by 2006 (Office of the President of the Republic of South Africa, 2007b). The implication is that the incidence of TB has increased from 269/100,000 to 720/100,000, and is one of the highest in the world (Department of Health, 2007).

Finally, international experience shows that land reform, an intervention which transfers assets into the hands of poor households, is potentially a long-term way of reducing the level and depth of poverty. This has been long recognized by the South African Government and, after social grants and housing grants, land reform is an important element of the country's policies for targeted transfers. Compared with land reform programmes in other countries, which are focused more on productive development, the South African land reform programme has a strong emphasis on equality and the redress of historical inequities, including those associated with gender. In the formulation of policy, particular attention has been paid to the interests of the rural poor and the interests of rural women (van den Brink and others, 2007). The initial land reform target for the redistribution programme was massive: to transfer 30 per cent of South Africa's 99 million hectares of farmland, or 30 million hectares, between 1994 and 1999. After three years of operation, about 200,000 hectares of land had been transferred to about 20,000 households, representing just 0.6 per cent of the target, and 0.2 per cent of the households demanding land. The slow delivery provoked claims that land reform was not working and several reviews of the original policies have resulted in more flexible strategies. Subsequent to 2002, the pace of delivery slowed, although it remains well above the levels achieved during the 1990s. The estimated number of land redistribution and land tenure projects in early 2005 was 2,025, with an estimated total of 100,000 beneficiaries, and some 11,000 beneficiaries having received land in 2004. Impact evaluations of progress that has been made conclude that South Africa's land reform was initially well targeted towards less resourced beneficiaries and that, once received, land does make a significant impact in terms of income (Deininger and May, 2000). However, the high failure

rate of the projects casts doubt on their sustainability without further support from the public and private sectors. This is especially so in the case of projects in which large groups must be formed in order to access grants (Hall, 2009).

Lessons learned

Despite its relative wealth when compared with other African countries and its adherence to much of the mantra of the Washington Consensus (fiscal discipline, macroeconomic stability, openness to trade and the protection of property rights), South Africa's experience does not offer simple solutions to the problem of poverty eradication. Instead, its economy has proven to be inefficient in terms of its ability to translate what economic growth has taken place into the prosperity of its population. According to Heltberg (2002), the poverty elasticity of growth, a measure that shows what decrease in poverty results from economic growth, has been well below that of countries in Asia and South America and little better than countries in sub-Saharan Africa that have far less developed economies. Nonetheless, there are a number of important lessons that can be derived.

First, although this has not yet been empirically demonstrated, it seems possible that high and growing inequality is a concern for poverty reduction in South Africa. Internationally, inequality, especially in terms of wealth, has been shown to slow economic growth, and economic growth has been shown to reduce poverty (Deininger and Olinto, 2000; Dollar and Kraay, 2000). Although the emergence of a non-racial middle class may have assisted in short-term political stability, recent divisions within the ruling party and its allies suggest growing dissatisfaction among those who have not yet benefited from the fruits of democracy (Bond, 2000).

Second, it is evident that substantial delivery of services and infrastructure has taken place through South Africa's decentralized system of local government. These form an important component of South Africa's strategy for poverty reduction, and it is apparent that a substantial proportion of the population has benefited from this delivery. It is also apparent that a much greater contribution would be possible if a number of efficiency concerns were addressed. These relate to underspending, skills constraints at the local level, poor coordination between government spheres and line functions, and inadequate attention directed towards maintenance. The South African experience also shows the extent of the policies and acts required to achieve effective decentralization and the need for ongoing policy reform as circumstances change. Indeed, many of the shortcomings that have been identified relate to slow or incomplete implementation of existing policies rather than to policy gaps. Finally, the steady surge in service delivery protests suggest that the services which have been delivered may not be affordable for the beneficiaries, or are not of the quality or consistency that they expect.

Third, to the extent that they can be afforded, social grants make an important

and direct contribution towards the reduction of poverty. Furthermore, such grants have been found to benefit both the recipients and other members of their households. The Child Support Grant has been shown to produce substantial reductions in stunting of young children and this is likely to produce, in turn, substantial increases in those children's productivity and wages once they grow up (Agüero and Valdivia, 2010). There are also likely indirect benefits. Case, Hosegood and Lund (2005) find that the Child Support Grant also results in an increase in school enrolment among 6-year olds and suggest several possible reasons for this, including that the Grant may improve children's health and nutrition, and thus school-readiness, as well as allow the household to afford fees, uniforms and other school-related expenses. Samson and others (2001) argue that receipt of pension income also can increase school enrolments, while Boler and Timæus (2006) find that the child grant contributes towards lessening the negative educational impact of orphanhood on older children.

Fourth, failure to attend to health care needs, especially those arising from HIV/AIDS, constrains prospects of achieving a reduction in poverty. As Steinberg and others (2002) note, two thirds of respondents surveyed in South Africa reported a fall in household income as a result of their actions to cope with the impact of HIV-related illness, including the direct loss of earners. Households reported increased expenditure on health, diverting income from other requirements, potentially with significant opportunity costs. Studies by May and others (2007) and Carter and others (2007) found that, on average, young adult deaths had an adverse impact on the growth expenditure per head of households in KwaZulu-Natal. In the period (1998-2004) young adult deaths had a particularly negative impact on households who received above the median income. This was because the young adults who died in these households did not have lower earnings than survivors, as was the case in poorer households. However, the economic impact of adult deaths varies by the age of the person dying, and over time, and depends on the economic characteristics of the affected household. The implication is that while the deaths of young adults (largely from AIDS) do not usually appear to be catastrophic for poor households at least in economic terms, no simple generalizations concerning the impact of adult mortality can be identified, and it does appear that illness and death hinder prospects of escaping poverty.

Finally, redistributive actions that transfer assets to poor households do appear to increase their incomes and their prospects of escaping poverty. However, in the case of land, and perhaps other forms of asset transfers, success in targeting does not necessarily translate into sustainable projects. Further support is required, including access to information, markets and social networks. Programmes involving the formation of large groups appear to be especially vulnerable, whereas programmes involving partnerships between better and less resourced beneficiaries appear more likely to succeed.

Conclusion

While South Africa's transformation contains many unique features, many of the findings of this chapter are applicable elsewhere in sub-Saharan Africa. Thus, it seems that the already high levels of poverty found in the 1960s peaked in the 1990s and may have declined in the first part of this century, but are likely to have risen during the economic crisis and rapid food price increases of 2008-2009. If the results from recent analyses are correct, despite a global downturn, many countries in Africa may now be on a long-term path of gradual asset accumulation for poor households, which may result in a reduction in structural poverty. However, the data discussed in this chapter give rise to two concerns.

The first is that there may be deep pockets of poverty in many parts of Africa that are not being adequately reached by government policy. The data from some regions show that there are areas with extraordinarily high levels of poverty in terms of all measures, and that within these areas, there may be severely deprived groups who have little chance of benefiting from Africa's wealth or the redistributive policies of its Governments.

The second concern is that the economies of many African economies remain inefficient in terms of their ability to translate economic growth into the prosperity of the continent's population. A useful tool here is known as the poverty elasticity of growth, which shows what decrease in poverty results from economic growth. Most African countries perform badly in this area, well below that of countries in Asia and South America (Heltberg, 2002). The reasons for this, including the possible influence of inequality, need to be better understood if the pace of poverty reduction is to be increased beyond its current sluggish rate. Even with the harnessing of this potential, it seems likely that deprivations will persist despite the availability of policies and resources that could be used to sustain poverty reduction.

References

- Agüero, Jorge M., and Martín Valdivia (2010). The permanent effects of recessions on child health: evidence from Peru. *Estudios Económicos*, vol. 25, No. 1 (49), pp. 247-274.
- Ajam, Tania, and Janine Aron (2007). Fiscal renaissance in a democratic South Africa. *Journal of African Economies*, vol. 16, No. 5, pp. 745-781.
- Alkire, Sabina, and Maria Emma Santos (2010). Acute Multidimensional Poverty: A New Index for Developing Countries. OPHI Working Paper No 38. Oxford: Oxford Poverty and Human Development Initiative.
- Bhorat, Haroon, Pranushka Naidoo and Carlene van der Westhuizen (2006). Shifts in non-income welfare in South Africa, 1993-2004. Development Policy Research Unit (DPRU) Working Paper 06/108, submitted to the DPRU Conference 2006, 18-20 October, Johannesburg.
- Boler, Tania, and Ian Timæus (2006). Father figures: Why fathers and cash grants matter in responding to the impact of AIDS on education. AIDS 2006—XVI International AIDS Conference, August 13 -18, Toronto, Canada.
- Bond, Patrick (2000). *Elite Transition: From Apartheid to Neoliberalism in South Africa*. Johannesburg: Wits University Press.
- Carter, Michael R., Julian D. May, Jorge Agüero and Sonya Ravindranath (2007). The economic impact of severe illness and prime age mortality: Evidence from panel data from KwaZulu-Natal, South Africa. *AIDS*, vol. 21, pp. S67-S73.
- Carter, Michael R., and Julian D. May (1999). Poverty, livelihood and class in rural South Africa. *World Development*, vol. 27, No.1, pp. 1-20.
- Case, Anne, Victoria Hosegood and Frances Lund (2005). The reach and impact of child support grants: Evidence from KwaZulu-Natal. *Development Southern Africa*, vol. 22, No. 4, pp. 467-482.
- Chandy, Laurence, Natasha Ledlie and Veronika Penciakova (2013). The final countdown: prospects for ending extreme poverty by 2030. Brookings Global Economy and Development Policy Paper 2013-04. April.
- Central Statistical Service (CSS) (1994). South African Labour Statistics 1993. Pretoria.
- de Gruchy, Joy (1960). *The cost of living for urban Africans*. Johannesburg: South African Institute of Race Relations.
- Deininger, Klaus, and Julian May (2000). Can there be growth with equity? An initial assessment of land reform in South Africa. Policy Research Working Paper No. 2451. Washington, D.C.: World Bank.

- Deininger, Klaus, and Pedro Olinto (2000). Asset distribution, inequality and growth. World Bank Development Research Group. Policy Research Working Paper No. 2375. June.
- Department of Health (2007). Draft tuberculosis strategic plan for South Africa, 2007-2011. Pretoria: Department of Health.
- Dollar, David, and Aart Kraay (2000). Growth is good for the poor. Policy Research Working Paper No. 2587. Washington, D.C.: World Bank.
- Dorrington, Rob, Leigh Johnson, Debbie Bradshaw and Timothy-John Daniel (2006). The demographic impact of HIV/AIDS in South Africa: National and provincial indicators for 2006. Centre for Actuarial Research Paper. Cape Town: University of Cape Town.
- Hall, Ruth (Ed.) (2009). *Another Countryside? Policy Options for Land and Agrarian Reform in South Africa*. Cape Town: PLAAS, University of the Western Cape.
- Heltberg, Rasmus (2002). The poverty elasticity of growth. World Institute for Development Economics Research (WIDER) Discussion Paper 2002/21. Helsinki: UNU-WIDER.
- Joint United Nations Programme on HIV/AIDS (2008). AIDS epidemic update 2008. Regional summary sub-Saharan Africa (March). Geneva: Joint United Nations Programme on HIV/AIDS and World Health Organization.
- International Monetary Fund, the Organization for Economic Cooperation and Development, United Nations and World Bank Group. 2000. A Better World For All: Progress towards the international development goals. IMF: Washington DC. Available at <http://www.imf.org/external/pubs/ft/jointpub/world/2000/eng/bwae.pdf>
- Keswell, Malcolm, Michael R. Carter and Klaus Deininger. (2009). "Poverty and Land Ownership in South Africa: Quasi-Experimental Evidence. Monitoring and evaluating the quality of life of land reform beneficiaries and the impact of land transfers." Pretoria, Department of Land Affairs.
- Leibbrandt, Murray, Ingrid Woolard, Arden Finn and Jonathan Argent (2010). Trends in South African income distribution and poverty since the fall of apartheid, OECD Social, Employment and Migration Working Paper No. 101. Organization for Economic Cooperation and Development.
- Matjila, Maila John, Anwar A. Hoosen, Anton Stoltz and Neil Cameron (2008). STIs, HIV and AIDS and TB: Progress and challenges. *South African Health Review*, Peter Barron and Josianne Roma-Reardon (eds.), pp. 89-102. Durban: Health Systems Trust. Available from <http://www.hst.org.za/publications/841>.

- May, Julian, Jorge Agüero, Michael R. Carter and Ian Timæus (2007). The KwaZulu-Natal Income Dynamics Study (KIDS) 3rd wave: methods, first findings and an agenda for future research. *Development Southern Africa*, vol. 24, No. 5, pp. 629-648.
- National Treasury (2005). Budget review, National Treasury. Pretoria.
- _____ (2007). Provincial budgets and expenditure review 2003/04-2009/10. Pretoria: National Treasury.
- _____ (2008). Local government budgets and expenditure review. National Treasury. Pretoria.
- Nattrass, Jill, and Julian D. May (1986). Migration and dependency: Sources and levels of income in KwaZulu. *Development Southern Africa*, vol. 3, No. 4, pp.583-599.
- Office of the President of the Republic of South Africa (2004). Accelerated and shared growth in South Africa—A summary. Pretoria.
- Office of the President of the Republic of South Africa (2007a). South Africa: Millennium Development Goals, mid-term country report. Pretoria.
- Office of the President of the Republic of South Africa (2007b). Development indicators mid-term review. Pretoria.
- Özler, Berk (2007). Not separate, not equal: Poverty and inequality in post-apartheid South Africa. *Economic Development and Cultural Change*, vol. 55, No. 3, pp. 487-529.
- Pimstone, Gideon (1998). Local government: Constitutional foundations. *Regionalism in the New South Africa*, Meshack Khosa and Yvonne Muthien (eds.). Aldershot: Ashgate Publishing.
- Poggenpoel, S., and M. Claasen (2004). Provincial comparative health budget brief 2004. *Budget Brief*, No. 150. Cape Town: IDASA..
- Samson, Michael, Oliver Babson, Claudia Haarmann, Dirk Haarmann, Gilbert Khathi, Kenneth Mac Quene and Ingrid van Niekerk (2001). The impact of social security on school enrolment in South Africa, Research Paper No. 25. Cape Town: Economic Policy Research Institute.
- South African Reserve Bank (1996). Quarterly Bulletin, December 1996, No. 202, Pretoria.
- Simkins, Charles (1984). What has been happening to income distribution and poverty in the homelands? *Development Southern Africa*, vol. 1, No. 2, pp. 19-42.
- Study Project of Christianity in Apartheid Society (SPRO-CAS) (1972). *Power, privilege and poverty*. Johannesburg: South African Council of Churches and Christian Institute of Southern Africa.

- Statistics South Africa (1999). Labour Force Survey September, 1998. Pretoria: Statistics South Africa.
- ____ (2001). South Africa in transition: Selected findings from the October household survey of 1999 and changes that have occurred between 1995 and 1999. Pretoria: Statistics South Africa.
- ____ (2005). Labour Force Survey September, 2004. Pretoria: Statistics South Africa.
- Steinberg, Malcolm, Saul Johnson, Gill Schierhout and David Ndegwa (2002). *Hitting Home: How Households Cope with the Impact of the HIV/AIDS Epidemic: A Survey of Households Affected by HIV/AIDS in South Africa*. Durban: Henry J. Kaiser Family Foundation/Health Systems Trust.
- Streak, J. (2005). Provincial budgets for developmental social welfare services over MTEF 2005/06: A vulnerable child perspective. *Budget Brief*, No. 158. Cape Town: IDASA.
- United Nations Development Programme (2003). Millennium Development Indicators for South Africa. Pretoria.
- ____ (2009). Statistics of the *Human Development Report*. New York: United Nations Development Programme.
- Van den Brink, Rogier, Glen Thomas, Hans Binswanger, John W. Bruce and Frank Byamugisha (2007). Consensus, confusion and controversy: Selected land reform issues in sub-Saharan Africa. World Bank Working Paper No. 71. Washington, D.C.: World Bank.
- van der Berg, Servaas, Ronelle Burger, Rulof Burger, Megan Louw and Derek Yu (2005). Trends in poverty and inequality since the political transition. Stellenbosch Economic Working Papers No. 1/2005. Bureau for Economic Research and University of Stellenbosch. Available from http://www.ber.sun.ac.za/downloads/2005/working_papers/WP-01-2005.pdf (accessed on 14 July 2009).
- Yemek, Etienne (2005). Understanding fiscal decentralization in South Africa. Africa Budget Project Occasional Paper. I.-B. I. Service. Cape Town: IDASA.
- World Bank and International Monetary Fund (2013). *Global Monitoring Report 2013: Rural-urban dynamics and the Millennium Development Goals*. Washington, D.C.: World Bank.

PART II

THE CHALLENGE OF BUILDING EMPLOYMENT FOR A SUSTAINABLE RECOVERY

Chapter 6

Employment matters

JOMO KWAME SUNDARAM²⁹

The 2005 World Summit put the goal of full and productive employment as well as decent work for all at the forefront of the United Nations development agenda. This essentially reaffirmed Article 55 of the United Nations Charter which states, “With a view to the creation of conditions of stability and well-being which are necessary for peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, the United Nations shall promote: higher standards of living, full employment, and conditions of economic and social progress and development....”

The 2005 Summit outcome document also reiterated one of the central commitments of the World Summit for Social Development held in Copenhagen in 1995, to achieve full employment, poverty reduction and social integration. Since the 2005 World Summit, the United Nations has prioritized full and productive employment and decent work for all in its deliberations.

The first Millennium Development Goal (MDG 1) of reducing poverty by half by 2015 cannot be met without economic and social policies aimed at achieving full and decent employment. In general, the generation of decent jobs should not be treated as an addendum to macroeconomic stabilization programmes or microeconomic liberalization reforms. Employment policies should be central to a broad, coherent and consistently countercyclical macroeconomic strategy for sustainable development, including a universal approach to social protection.

The issue of full and productive employment is not relevant for developing countries only, as the recent crises remind us. While the global economic recovery remains anaemic, most developed economies continue to face high, if not growing, unemployment. Average unemployment in developed countries rose from under 6 per cent in 2007 to over 8 per cent in 2012 (International Labour Organization, 2013). In the United States of America, the unemployment rate is on the rise

²⁹ I am indebted to Anis Chowdhury for assistance in finalizing this chapter. Nevertheless, he should not be held accountable for any remaining mistakes or controversies.

again, with 12.3 million Americans without work, bringing the unemployment rate to 7.9 per cent in January 2013. The jobless rate in Spain in the last three months of 2012 rose to 26 per cent, or close to 6 million people, the highest since the mid-1970s. The unemployment rate in Greece also increased in the final quarter of 2012 to almost 27 per cent, the highest in the European Union. The unemployment rate in the 17-nation euro zone climbed to 11.9 per cent in January of 2013, according to Eurostat.³⁰

Long-term unemployment has continued to rise in many developed countries, reaching 40 per cent of the unemployed in half of these countries. The share of long-term unemployed has risen significantly in the United States, the United Kingdom of Great Britain and Northern Ireland, and the debt-distressed euro zone countries. Youth unemployment has also increased markedly. In Spain, youth unemployment surged to 55 per cent, and in Greece, it reached around 60 per cent towards the end of 2012.

However, policymakers in most advanced countries remain focused on reducing fiscal deficits and public debt in the hope of inspiring market confidence. This appears to ignore lessons from historical experience. For example, to secure re-election in 1936, President Roosevelt promised “a balanced budget”. After securing re-election, he proceeded to cut government spending in 1937, citing the threat of inflation; soon, unemployment shot up to 19 per cent.

The Keynesian revolution implied that public finance deficits and surpluses should be adjusted countercyclically over the business cycle (Matthews, 1968). Thus, government fiscal balances should help smooth business cycles in order to achieve full employment. Also, Governments were increasingly expected to build infrastructure and provide public services such as health care and education. This inspired the United Kingdom’s “full employment compact” after the Second World War (Abel-Smith, 1992) and the adoption of “maximum employment” as a key policy goal in the United States (Strayer, 1950).

In the 1970s, economic stagnation and inflation in developed countries contributed to the ascendance of new anti-Keynesian economics, including the “new classical macroeconomics”, which does not foresee the possibility of involuntary unemployment caused by insufficient aggregate demand. It also presumes that labour markets will “clear” if flexible enough. Therefore, any significant and persistent unemployment was either voluntary (due to optimizing economic agents collectively preferring to “consume” more “leisure”) or caused by labour market distortions and rigidities.

Thus, full employment was largely replaced as a key macroeconomic goal, with central banks pursuing “inflation-targeting” and finance ministries embracing fiscal balance to serve the inflation-targeting monetary policy, in the hope that full employment and rapid growth would follow by “divine coincidence” (Blanchard

30 The United States jobless figures are from the United States Department of Labor Statistics and the figures for the European countries are from Eurostat.

and Gali, 2005). The new policy emphasis shifted to either removing labour market rigidities or making work more attractive by scaling back “generous” unemployment benefits that allegedly induce long periods of job search, complemented by appropriate training to enhance “employability” (e.g., see the Organization for Economic Cooperation and Development (OECD) jobs report of the mid-1990s (Organization for Economic Cooperation and Development, 1994)).

The decline of the full employment commitment in advanced economies and the official turn to employability, inflation-targeting and fiscal prudence also impacted policymaking in developing countries. The policy regime change followed the 1980s debt crisis in many developing countries, especially in Latin America. Commercial banks, especially in the United States and the United Kingdom—flush with petrodollars (deposits by the Governments and others from oil exporting countries)—were keen to lend, and borrowing countries were happy to borrow, after some persuasion, in the light of low real interest rates owing to high inflation.

The development strategy of international financial institutions sought to ensure “efficiency-enhancing” structural adjustment and labour market reforms, and macroeconomic stability through inflation targeting and fiscal prudence, to unleash latent productive potential. More than 900 structural adjustment programmes were implemented in developing countries between 1980 and 1998. It was believed that sustained job creation and poverty reduction would be the outcome of the new policy framework. After almost two decades of apparent failure and criticism, the Bretton Woods institutions ostensibly replaced structural adjustment programmes from 1999 with supposed poverty reduction strategies, which essentially maintained the same policy framework.

Broad structural reforms—involving privatization, financial deregulation and trade liberalization, and the new macroeconomic policy priorities—since the early 1980s adversely affected employment opportunities in most developing countries except in about a dozen or so countries which were well placed to enhance their exports. Perhaps, faith in “divine coincidence” was so strong that full and productive employment was not mentioned when the MDGs were first articulated in 2001. Although the 2005 Summit corrected this shortcoming, employment has not received as much attention as other targets for monitoring purposes as no target date was specified. By the middle of the last decade, the employment content of Poverty Reduction Strategy Papers (PRSPs) was low in 7 of the 21 African countries with full PRSPs and medium-low in another 13 countries; only the United Republic of Tanzania’s PRSP had a high employment content (Nkurunziza, 2007). Thankfully, there has been some change of heart since—for example, see the 2013 *World Development Report* on jobs (World Bank, 2012).

Economic liberalization and employment

Trade liberalization has not brought about economic growth to all developing countries.³¹ The World Bank (2002) found that developing countries that integrated into the world economy most rapidly during 1977-1997 were not necessarily those that had adopted policies promoting trade liberalization. Trade liberalization has induced structural change in many countries, and such change has brought about both job destruction and job creation. The net employment effect, therefore, depends on efficiency gains, productivity growth and most importantly, exchange rate competitiveness. However, many developing countries do not have the capacity to rapidly raise productivity through trade liberalization. Consequently, job losses in import-competing sectors are often much greater than new jobs created in export competitive sectors (see, for example, Olayiwola and Rutaihwa, 2010).

Even among “successful” developing country globalizers regarded as regional “models”, there were temporary increases in unemployment following trade reform (Rama, 2003). Where trade liberalization created jobs, in many instances, they were of poor quality, lacking job security as well as decent working conditions and pay (see, for example, Pholphirul, 2007). Female workers have been particularly affected by this trend as there has often been some feminization of employment in labour-intensive export sectors (Dias, 2010). In some developing countries, trade liberalization has failed to bring about dynamic structural change. Export enclave development has been typically dominated by footloose industries which have often moved on to lower-cost locations.

In sum, increased trade openness in many developing countries has resulted in large adjustment costs, including increased income inequality, unemployment and limited creation of decent jobs (Jansen and Lee, 2007). Economies have become much more dependent on externally determined technological change and sources of productivity growth. In many cases, these factors have reduced demand for labour in developing countries.

Starting in the 1980s, financial sector deregulation was encouraged under the assumption that low administratively determined interest rates were detrimental to growth, by discouraging savings and encouraging the inefficient use of capital. It was also argued that growth would be enhanced by opening the capital account of the balance of payments. This would attract much greater foreign capital inflows. Instead, however, financial deregulation has raised real interest rates, while its impact on domestic saving and investment has been mixed (see Reinhart and Tokatlidis, 2005; Galbis, 1993). The elimination of specialized financial institutions, coupled with higher interest rates, have actually reduced access to finance of employment-intensive small and medium-size enterprises (SMEs),

31 See chapters by G. Andrea Cornia, Eddy Lee and Bernard Hoekman, and L. Alan Winters in Ocampo, Jomo and Khan (eds) (2006). Also see Jomo, Schwank and von Arnim (2011).

including those in the agricultural sector. To make banks profitable again, a wave of bank mergers followed. There is a considerable body of work showing that this caused further exclusion of SMEs and small borrowers from formal credit markets.³²

External or international financial liberalization or financial globalization has contributed to the surge in international capital flows since the early 1990s. While the direct growth benefits of financial openness are dubious, many developing countries have also experienced greater economic volatility and macrofinancial instability and crises. In their study of 53 countries during 1980-1995, Demirgüç-Kunt and Detragiache (1998) found that banking crises were more likely to occur in liberalized financial systems. These crises have had considerable adverse impacts on gross domestic product (GDP) and long-term growth prospects, while labour has suffered disproportionately as job recovery typically lags behind output recovery. For example, the financial crises between 1994 and 2002 pushed approximately 40 million to 60 million people into poverty (Cline, 2002).

Macroeconomic stabilization and employment

Since the early 1980s, macroeconomic policy has often sought to stabilize inflation rates at between 3 and 5 per cent. It is presumed that low inflation encourages savings and investment, removes distortions in resource allocation and improves the efficiency of investment. Large fiscal deficits have been identified as a major reason for higher inflation. Fiscal deficits are also presumed to crowd out private sector investment.

On these premises, developing countries have been advised to reduce their deficits and to maintain a primary budget surplus. Low inflation and balanced budgets are supposed to reduce financing costs, and thus promote growth and employment. The current dominant approach to central banking does not focus on either output growth or employment generation, but rather on keeping inflation rates within the low single digits.

However, employment generation and economic growth are rarely, if ever, by-products of inflation-focused central bank policy management. Summarizing lessons from the 1990s, the World Bank (2005, p. 95) concluded, “Macroeconomic policies improved in a majority of developing countries in the 1990s, but the expected growth benefits failed to materialize, at least to the extent that many observers had forecast. In addition, a series of financial crises severely depressed growth and worsened poverty.”

Instead, the macroeconomic policy conventional wisdom of the past three decades has resulted in declining public investment, output growth volatility and high borrowing costs (Chowdhury and Islam, 2011). Revenues fell in many developing countries owing to trade liberalization with the removal of trade-

32 See Bagchi and Dymski (2007); Chandrasekhar and Pal (2006) and Pillarisetti (2007) for evidence from India.

related taxes which were not replaced by increased revenues from other sources or by other tax reforms. With lower revenues, these countries were forced to further cut public investment to attain fiscal balance. Reviewing the situation, an International Monetary Fund (IMF) (2004, p. 3) report noted, “The share of public investment in GDP, and especially the share of infrastructure investment, has declined during the last three decades in a number of countries, particularly in Latin America. Since the private sector has not increased infrastructure investment as hoped for, significant infrastructure gaps have emerged in several countries.”

The primary focus on price stability, benchmarked to single-digit inflation and balanced budgets, has made macroeconomic policies procyclical. Monetary policy aimed at keeping inflation low tends to result in high real interest rates, often detrimental to growth and employment generation. In conjunction with tight fiscal policies, austere monetary policy has reduced demand for productive loans, and consequently, investments and growth, thus adding to global employment problems.

In addition, higher interest rates attract short-term capital flows which add to inflationary pressure, requiring further tightening of monetary policy. At the same time, exchange rates appreciate due to high short-term capital inflows, adversely affecting employment-intensive export-oriented sectors.

In sum, the narrow focus on macroeconomic stabilization, coupled with financial liberalization, has often imposed constraints on growth and employment in developing countries. Governments are compelled to reduce fiscal expenditures to keep down inflation and to retain the confidence of foreign investors, even in the presence of underutilized capacity and large-scale unemployment. Policies tend to be deflationary, prompting reductions in consumption and hindering employment creation. In addition, capital inflow surges have been damaging, albeit with different consequences compared with capital outflows. The costs of sterilization to avoid exchange rate appreciation and the opportunity cost of maintaining increased reserves have been high.

Fiscal austerity and employment

Both developed and developing countries responded to the recent crises with expansionary policies to stem the sharp decline in aggregate demand across the world.³³ According to the International Labour Organization (ILO) (2010), Group of Twenty (G20) Governments saved or created an estimated 21 million jobs in 2009 and 2010. Policy interest rates remained historically low throughout 2009 to stave off a potential depression. Key international institutions, ranging from the IMF to the OECD, all became Keynesian, urging national policymakers to adopt and sustain fiscal interventions.

33 By April 2009, liquidity injections into the financial system and bailouts of some major financial institutions had cost over \$18 trillion, or almost 30 per cent of world gross product (WGP), while fiscal stimulus packages for 2009-2011 were expected to cost about \$2.7 trillion, or 4 per cent of WGP.

However, the policy discourse changed in developed countries, as reflected at the June 2010 Toronto Summit of the G20, with key Governments calling for fiscal consolidation to bring sovereign debt down to sustainable levels. In the words of the *Economist* (2010), “Across much of the rich world an era of budgetary austerity beckons.” A leading advocate of this view, Fatas (2010, p. 7) argued, “Given that the current levels of debt are high by historical standards and that they are very high in many advanced economies, it might be that markets will soon ask for a strong signal of commitment and, in its absence, risk premia on government bonds will increase. To avoid an increasing cost of rolling over the debt, governments could be better off with a strong early adjustment.”

There are various ways in which a fiscal consolidation programme can achieve its goal without imposing any output or employment loss or, even better, accompanied by growth and employment creation. For example, an IMF study (Dermott and Wescott, 1996) of 74 cases of fiscal consolidation in 20 industrialized countries during 1970-1995 concluded that in 14 “successful” cases, there was sustained reduction of the debt-to-GDP ratio (by about 3 percentage points over three years) as well as increased growth and employment creation. Similarly, Alesina and Ardagna (2010) found 27 cases of fiscal consolidation with growth among 107 episodes of fiscal consolidation in OECD countries during 1970-2007 (Alesina, 2010).

In the cases of “successful” fiscal consolidation accompanied by growth and employment creation, other factors often played a more important role than the fiscal actions per se, including the global business cycle, monetary policy, exchange rate policy and structural reforms. For instance, the IMF study by Dermott and Wescott (1996, p.10) noted that “strong global economic growth helps to achieve a successful consolidation, and weak global growth reduces the chances that consolidation will cut the debt-to-GDP ratio”. Expansionary monetary policy also seemed to have offset the recessionary consequences of fiscal retrenchments. Similarly, devaluation that boosts net exports may help offset the decline in aggregate demand as a result of fiscal austerity. Finally, in the long-run, growth and employment expansion owing to structural reforms may outweigh the negative growth and employment impacts of austerity measures.

The United Nations Conference on Trade and Development (UNCTAD) *Trade and Development Report 2011* argued that premature fiscal austerity contributed to a vicious circle of low growth and high public debt. The IMF *World Economic Outlook 2010* claimed that fiscal consolidation typically reduced output and raised unemployment in the short term. A fiscal cut of 1 per cent of GDP typically reduced output by about 0.5 per cent within two years, and raised unemployment by about 0.3 per cent. The IMF also suggested that simultaneous budget deficit cuts in many countries were likely to have a cumulatively adverse effect. In the *World Economic Outlook 2012*, the IMF acknowledged serious underestimation of the values of multipliers at the time; hence, the actual adverse output and employment impacts are likely to have been much larger—as is clear from more recent evidence cited earlier.

Using data from the past 30 years, recent IMF research (Ball, Leigh and Loungani 2011) found that fiscal consolidation raised both short- and long-term unemployment, with its impact on long-term unemployment much greater, hurting wage earners disproportionately more than profit- and rent earners. Thus, it concludes, "... slamming on the brakes too quickly will hurt the recovery and worsen job prospects. Hence the potential longer-run benefits of fiscal consolidation must be balanced against the short- and medium-run adverse impacts on growth and jobs."

The ILO *World of Work Report 2011* reviewed the extent to which budget cuts can be counterproductive, from both employment and fiscal perspectives, and assessed efforts to maximize the employment impact of fiscally constrained labour market policies through good design. The simulation exercise showed that spending cuts that increase unemployment will erode the tax base, stretch social budgets and thus significantly reduce—and, in some cases, entirely eliminate—the fiscal savings from spending cuts.

Recent work at the ILO (Matsumoto, Hengge and Islam, 2012) found a direct relationship between youth unemployment and fiscal austerity. The correlation between changes in the general government structural fiscal balance (share of potential GDP) and changes in youth unemployment rates in Europe during 2009-2011 was found to be 0.69. The increase in youth unemployment rates between 2009 and 2011 tended to be higher for economies undertaking stronger fiscal tightening measures. Simple regression estimates ($R^2 = 0.47$) suggest that a percentage point increase in the structural (cyclically adjusted) fiscal balance raised the youth unemployment rate by 1.5 percentage points, while 47 per cent of the variation in youth unemployment rates across the OECD can be attributed to fiscal policy differences. More elaborate macroeconomic models suggest that "if austerity measures continue in the current form until the first half of 2013, employment in the group of advanced countries is expected to grow only moderately—by 0.2 per cent" (ILO, 2012, p. 69).³⁴

Labour market flexibility and employment

As unemployment has risen sharply and continues to remain high, policy advocacy of labour market flexibility has gained added momentum. In fact, the recent crises have triggered further deregulation of labour markets. While the World Bank (2009, p. 4) has suggested short-term policies to stabilize employment and income, it maintains that "overly stringent employment protection laws constrain firm hiring and lead to suboptimal level of employment, a feature particularly important during economic downturns".

34 The findings of the analysis show that the ratios of public investment and public wages to total expenditure have a positive and significant impact on employment in the short term and during times of crisis. A 1 percentage point increase in each of these two ratios would raise employment by 0.43 and 0.3 per cent, respectively.

Alejandro Foxley (2009), former Foreign Minister and Finance Minister of Chile, argues that the economic crisis provides opportunities to remove labour market protection, stating that labour reform is always politically contentious, but the current crisis, by illustrating the dangers of ignoring necessary long-term reforms, has made it easier to reach consensus on the need for action. Labour market regulations are seen by many as detrimental to job creation, growth and innovation. It is argued that employment protection legislation in developing countries tends to reduce the creation of formal sector salaried jobs, encourage the growth of the informal sector, and thus slow investment and growth. Therefore, reform of labour market institutions is needed to increase labour market flexibility to provide incentives for job creation. Pressure to make labour markets more flexible has been reinforced by the transfer of production and jobs to emerging economies, especially in Asia.

The apparent consensus claiming a link between labour market flexibility and economic performance has been challenged by several empirical studies. OECD (2006) concedes that it is not easy to identify a uniquely optimal set of labour market institutions that engender and sustain economic prosperity. A variety of regulatory regimes governing the labour market are compatible with good economic performance. Other studies, such as Berg and Kucera (2008), conclude that one cannot, on the basis of available evidence, maintain that deregulating labour markets will lead to faster job creation and more growth. Although the World Bank 2013 *World Development Report* promotes labour market flexibility, its message is more nuanced. For example, it acknowledges, “In most cases, however, the constraints to creating transformational jobs are not connected to the labor code (...). There is no consensus on what the content of labor policies should be.” (World Bank, 2012, p. 26-27.)

Advocacy of labour market flexibility overlooks three key considerations. First, countries with “labour-friendly” regulations seem to lower wage inequality. Freeman (2007) suggests that regulations protecting labour rights tend to lower inequality without any significant loss of output and employment.

Second, the recent discourse on flexibility refers to a regime of “employment at will” (Santos, 2009), where Governments impose no restrictions on hiring and firing, or on employment conditions; both employers and workers would be free to choose terms of employment to their mutual satisfaction. But in reality, only flexibility for employers is advocated (see the World Bank’s *Doing Business*³⁵ surveys). In good times, with close to full employment, such asymmetrical flexibility may not be significant. But in bad times, if firms are allowed to cut wages or to fire at will, for example, in order to reduce costs, such flexibility for employers implies greater insecurity for most workers, albeit unevenly.

Third, speeding up labour market adjustments to cope with the global economic crisis runs the risk of impairing long-term growth potential if regulatory changes create a “low pay–low productivity trap”. Investors compete exclusively on the

35 World Bank’s *Doing Business*: <http://www.doingbusiness.org/data>.

basis of wage costs with little incentive to invest to enhance labour productivity. If each and every country attempts to lower labour standards and wages in order to enhance attractiveness to investors, such competition would result in a “race to the bottom”, benefiting no country while leaving all workers worse off.

There is an implicit normative message in the basic model of labour market competition that “any job is better than no job”, undermining the value of strengthening job security. In the absence of formal risk-mitigation schemes, workers could be induced to readily accept low productivity jobs at low wages, possibly sending the economy into a “low wage–low productivity trap”, with “bad jobs” driving out “good jobs”.

High worker turnover induced by greater labour market flexibility might also reduce incentives for employers to invest in training for their employees and for workers to acquire training. In the absence of job security and legal protection, workers pay a premium (in the form of low wages and willingness to accept any job) to employers to reduce the risk of being unemployed. Under such circumstances, higher labour standards and risk-mitigation schemes could be both efficient (inducing an economy towards a “high productivity, high wage equilibrium”) and equitable (enabling vulnerable workers to better deal with labour market risks).

Precarious and informal employment

Globalization, procyclical macroeconomic policies and labour market deregulation have encouraged poorly paid, insecure and unprotected employment. As a result, employment has become increasingly precarious (Rodgers and Rodgers, 1989; Standing, 2011). Part-time employment, self-employment, fixed-term work, temporary work and other non-standard forms of employment have grown. Typically, workers are not in such precarious employment by choice.

Precarious or non-standard forms of employment were already widespread in developed countries before the crises. For example, the ILO *World of Work Report 2008* showed that the incidence of part-time and temporary employment in advanced countries has been increasing since the mid-1990s (also see Houseman and Osawa, 2003). However, there has been a rise in precarious employment in developed countries in recent years, especially owing to the tepid recovery and fiscal austerity. According to the ILO *World of Work Report 2012*, involuntary part-time and temporary employment increased in two thirds of developing countries and more than half of advanced economies, respectively. The *World of Work Report 2012* noted a high share of informal employment, of more than 40 per cent, in two thirds of emerging and developing countries for which data are available. Women and youth are disproportionately affected by precarious employment conditions.

Way forward

Structural factors—such as mismatch between skills and job requirements or inadequacy of the educational and training system, as well as poorly designed labour market and social security systems—can certainly contribute to unemployment. However, these factors cannot adequately explain the recent unemployment spike in terms of the skills mismatch that has been worsening significantly since 2007.

Furthermore, there has been a reduction, rather than an increase, in employment protection legislation in most countries, especially in the advanced economies. Similarly, it is difficult to argue that red tape and bureaucratic impediments to employment generation have worsened significantly since the 2008-2009 global financial and economic crises. Instead, the decisive shift from fiscal stimulus to fiscal austerity after 2009 has been borne disproportionately by unemployed young people.

Measures to boost consumer confidence and aggregate demand are not helped by widespread layoffs or lower wages—ostensible structural adjustments to boost productivity and competitiveness, key planks of the current policy approach to the European Union jobs crisis. While wage reduction by some firms may increase their profitability relative to competitors, when all firms cut wages, they engender the “paradox of thrift”, further depressing aggregate demand, thus compounding the contractionary consequences of fiscal tightening.

Therefore, while policymakers should design labour market, training and education programmes to enhance overall employability, they should also implement policies to increase labour demand. They should pursue a longer-term countercyclical approach to fiscal consolidation and find fiscally neutral ways by which targeted interventions for job creation can be supported. For example, making it mandatory for public sector organizations to hire long-term unemployed young workers for, say, two years, by spending the equivalent of the unemployment and job search benefits that would otherwise be spent on them could be fiscally neutral. This would transform the role of government from a provider of unemployment and job search benefits into an employer of last resort.

The guiding principle for macroeconomic policy should be consistent with the preamble of article IV of the IMF Articles of Agreement which states, “each member shall endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances”. With these Bretton Woods norms of central bank policy, employment creation and more rapid economic growth are key goals besides ensuring monetary and financial stability.³⁶

36 At an IMF workshop in March 2011, Oliver Blanchard, the IMF chief economist, rejected the dominant macroeconomic paradigm of the past three decades: “Before the crisis, mainstream economists and policymakers had converged on a beautiful construction for monetary policy. To caricature just a bit: we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was

Central bank policies can affect foreign demand for exports through the real exchange rate, and domestic demand by reducing the costs of credit and increasing its availability. Central bank policy for employment creation should therefore focus on enabling aggregate demand expansion, making credit available for investment and maintaining a stable and competitive real exchange rate to support export demand.

Allowing central banks to promote growth and employment generation, however, may increase the risk of runaway inflation in the event of supply-side shocks, as happened during the 1970s oil price shocks. Possible remedies include tripartite or collective wage bargaining and fixing mechanisms, backed by increased government social spending and directed credit allocation to employment-generating sectors and firms. While the former dampens wage demands and thus helps avoid wage-price inflationary spirals, the latter can protect employment from the effects of a general credit crunch that would be triggered if policy were to rely solely on the rather blunt instrument of interest rate hikes. In the case of inflationary pressures from imported food prices, Governments can consider supplying food grains from stocks if available.

Available evidence from emerging market economies suggests that moderate inflation, that is inflation under 15 to 20 per cent, does not have negative effects on growth (e.g., Bick, 2010; Pollin and Zhu, 2006). On the other hand, moderate inflation expands Governments' fiscal space through seigniorage revenue and the "inflation tax", referring to slightly diminished real income owing to higher prices and, hence, costs. Instead of relying on such an "inflation tax", Governments should make serious political commitments to raise domestic revenue to ensure fiscal sustainability.

Fiscal sustainability also depends on ensuring adequate productive investments. Hence, Governments should invest in social and economic infrastructure, which not only enhances productivity, but also induces or "crowds in"—rather than "crowds out"—private investment. This also enhances the political feasibility of tax reform to raise revenue, as tax payers will benefit from better social and physical infrastructure and can clearly see the results of enhanced revenue collection.

Fiscal policy should be consistently countercyclical, building surpluses during booms and inducing recoveries during economic slowdowns by increasing Government expenditure despite running budgetary deficits. In addition to strengthening automatic stabilizers to reduce vulnerability to shocks and job losses, Governments should also adopt short- and long-term policies to mitigate the adverse impacts of economic reforms. For example, Governments can increase

basically enough to get things done... If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments. How you map the instruments onto the targets, and how you use these instruments best is a very complicated problem." (Blanchard, 2011, p. 1.)

public sector expenditures where underutilized capacity exists, particularly in rural areas where unemployment levels may be higher, in order to generate employment and increase incomes. As noted earlier, social wage provisioning (through subsidized public education, health care, housing, etc.) can be used to offset potential inflationary pressures from the removal of inefficient subsidies and price liberalization. Therefore, fiscal policy should be judged from the perspective of its impacts on productivity and employment, and not merely from a simplistic accounting perspective of balancing the budget in all circumstances.

Employment and growth-oriented macroeconomic policies, as outlined above, are likely to need appropriate capital account management. This sovereign right is provided for by article VI, section 3, of the IMF Articles of Agreement. However, such capital controls should discriminate between greenfield foreign direct investment and other financial inflows, considering the differing potential of different types of inflows to contribute to economic growth and employment creation.

An international financial system consistent with employment objectives should provide liquidity when needed, stability for global markets and enough space for policy autonomy for all countries. Policy coherence is needed at three levels—policies in industrialized countries, multilateral rules and policies in developing countries—for an international financial system more conducive to growth and employment.

By eliminating an important source of revenue through tariff reductions, trade liberalization reduced Governments' fiscal space in many developing countries. It also removed an important policy instrument to influence structural change. Therefore, in attempting to integrate developing countries effectively within the world trading system, there should be what UNCTAD calls "a positive trade agenda". This implies helping developing countries to enhance their productive and export capacities—thus overcoming supply constraints. Developing countries should not be asked to give up their right to formulate development-oriented trade policies in meeting their World Trade Organization (WTO) obligations.

References

- Abel-Smith, Brian (1992). The Beveridge Report: Its origins and outcomes. *International Social Security Review*, vol. 45, No. 1-2, pp. 5-16.
- Alesina, Alberto (2010). Fiscal adjustments: Lessons from recent history. Paper prepared for the ECOFIN meeting, Madrid. 15 April. Available at www.economics.harvard.edu/faculty/alesina/files/Fiscal%2BAadjustments_lessons.pdf
- Alesina, Alberto, and Silvia Ardagna (2010). Large changes in fiscal policy: Taxes versus spending. *Tax Policy and the Economy*, vol. 24, No.1, pp. 35-68.
- Bagchi, A.K., and Gary Dymksi (eds.) (2007). *Capture and Exclude: Developing Economies and the Poor in Global Finance*. New Delhi: Tulika.
- Ball, Laurence, Daniel Leigh and Prakash Loungani (2011). Painful medicine. *Finance & Development*. September.
- Berg, Janine, and David Kucera (eds.) (2008). *In Defence of Labour Market Institutions: Cultivating Justice in the Developing World*. Houndmills: Palgrave Macmillan.
- Bick, Alexander (2010). Threshold effect of inflation on economic growth in developing countries. *Economic Letters*, vol. 108, No. 2, pp.126-129.
- Blanchard, Olivier (2011). Monetary policy in the wake of the crisis. Presentation given at the International Monetary Fund Macro Conference. Available from <http://www.imf.org/external/np/seminars/eng/2011/res/pdf/ob2presentation.pdf>.
- Blanchard, Olivier, and Jordi Gali (2005). Real wage rigidities and the new Keynesian model. MIT Department of Economics Working Paper No. 05-28. Cambridge, MA; and Federal Reserve Bank of Boston Working Paper No. 05-14. Boston, MA.
- Chandrasekhar, C. P., and Parthapratim Pal (2006). Financial liberalization in India: An assessment of its nature and outcomes. *Economic and Political Weekly*, vol. 41, No. 11, pp. 975-988.
- Chowdhury, Anis, and Iyanatul Islam (2011). Attaining the Millennium Development Goals: The role of macroeconomic policies. *International Journal of Social Economics*, vol. 38, No. 12, pp. 930-952.
- Cline, William (2002). Financial crises and poverty in emerging market economies. Center for Global Development Working Paper No. 8, June, Washington, D.C.
- Cook, Paul, and Yuichiro Uchida (2003). Privatization and economic growth in developing countries. *The Journal of Development Studies*, vol. 39, No 6, pp. 121-154.
- Demirgüç-Kunt, Asli, and Enrica Detragiache (1998). Financial liberalization and financial fragility. Policy Research Working Paper No. 1917, World Bank, Washington, D.C.

- Dermott, C. John, and Robert Wescott (1996). Fiscal reforms that work. *Economic Issues*, No. 4, International Monetary Fund, Washington, D.C.
- Dias, Vivianne (2010). Beyond barriers: The gender implications of trade liberalization in Latin America. Latin America Trade Network Working Paper No. 122, May.
- Economist* (2010). Fiscal tightening and growth. 31 March.
- Fatas, Antonio (2010). The economics of achieving fiscal sustainability. Paper presented to Board of Governors, US Federal Reserve 9 April.
- Foxley, Alejandro (2009). Recovery: The global financial crisis and middle-income countries. Available from http://www.carnegieendowment.org/files/middle_income.pdf.
- Freeman, Richard (2007). Labor Market Institutions Around the World. NBER Working Paper No. W13242. Cambridge, MA: National Bureau of Economic Research.
- Galbis, Vicente (1993). High real interest rates under financial liberalization: Is there a problem? IMF Working Paper No. 93/7. Washington, D.C.: International Monetary Fund.
- Houseman, Susan, and Machiko Osawa (2003). *Nonstandard work in developed economies: Causes and consequences*. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.
- International Labour Organization (1998). Managing the Privatization and Restructuring of Public Utilities (Water, Gas, Electricity). Available from <http://www.ilo.org/public/english/dialogue/sector/techmeet/tmpu99/tmpure2.htm>.
- ____ (2008). *World of Work Report 2008: Income Inequalities in the Age of Financial Globalization*. Geneva: International Labour Office.
- ____ (2010). Accelerating a job-rich recovery in G20 countries: Building on experience. Report for the Washington meeting of the G20 Labour and Employment Ministers, 20 and 21 April.
- ____ (2011). *World of Work Report 2011: Making Markets Work for Jobs*. Geneva: International Labour Office.
- ____ (2012). *World of Work Report 2012: Better Jobs for a Better Economy*. Geneva: International Labour Office.
- International Monetary Fund (2004). Public investment and fiscal policy. Fiscal Affairs Department, International Monetary Fund, Washington, D.C.
- ____ (2010). *World Economic Outlook 2010*. International Monetary Fund. Washington, D.C.:
- ____ (2012). *World Economic Outlook 2012: Growth Resuming, Dangers Remain*. International Monetary Fund. Washington, D.C.

- Jansen, Marion, and Eddy Lee (2007). *Trade and Employment: Challenges for Policy Research*. Geneva: World Trade Organization and International Labour Office.
- Jomo Kwame Sundaram, Oliver Schwank and Rudiger von Arnim (2011). Globalization and development in sub-Saharan Africa. DESA Working Paper No. 102, Department of Economic and Social Affairs, United Nations, New York. Published as a book with the same title by the United Nations in 2013.
- Matsumoto, Makiko, Martina Hengge and Iyanatul Islam (2012). Tackling the youth employment crisis: a macroeconomic perspective. ILO Working Paper No. 124. Geneva: International Labour Office.
- Matthews, R. C. O. (1968). Why has Britain had full employment since the war? *Economic Journal*, vol. 78, pp. 555-569.
- Nkurunziza, Janvier D. (2007). Nkurunziza, J. (2007) 'Generating rural employment in Africa to fight poverty', in Ocampo, J. & Jomo, K. S. (eds) *Towards Full and Decent Employment*, New York: United Nations.
- Ocampo, José Antonio, Jomo Kwame Sundaram and Sarbuland Khan (eds.) (2006). *Policy Matters: Economic and Social Policies to Sustain Equitable Development*. London: Zed Books.
- Organization for Economic Cooperation and Development (1994). *The OECD Jobs Study: Facts, Analysis, Strategies*. Paris: Organization for Economic Cooperation and Development.
- ____ (2006). *OECD Employment Outlook 2006*. Paris: Organization for Economic Co-operation and Development.
- Olayiwola, Wumi, and Johansein Rutaihwa (2010). Trade liberalization and employment performance of textile and clothing industry in Tanzania. *International Business Research*, vol. 3, No. 3, July, pp. 47-55.
- Penketh, Anne (2002). Children are victims of privatization, warns charity. *Independent* (United Kingdom). 21 August.
- Pholphirul, Piriya (2007). Labour-market issues under trade liberalization: Implications for Thai workers. *Asia-Pacific Development Journal*, vol.14, No. 1, pp. 41-71. June.
- Pillarisetti, Satish (2007). Development finance as an instrument of poverty reduction: Outcome of two distinct phases in India. Paper presented at the Conference on Poverty and Capital, 2-4 July. Brooks World Poverty Institute University of Manchester. Available from <http://www.sed.manchester.ac.uk/research/events/conferences/povertyandcapital/satish.pdf>. (accessed on 20 March 2013).
- Pollin, Robert, and Zhu Andong (2006). Inflation and economic growth: a cross-country nonlinear analysis. *Journal of Post-Keynesian Economics*, vol.28, No. 4, pp. 593-614.

- Rama, Martin (2003). Globalization and workers in developing countries. Policy Research Working Paper No. 2958. Washington, D.C.: World Bank.
- Reinhart, Carmen, and Ioannis Tokatlidis (2005). Before and after financial liberalization. MPRA Paper No. 6986, Munich Personal RePEc Archive. Available from <http://mpra.ub.uni-muenchen.de/6986/> (accessed on 4 February 2008).
- Rodgers, Gerry, and Janine Rodgers (eds.) (1989). *Precarious Jobs in Labour Market Regulation: The Growth of Atypical Employment in Western Europe*. Geneva: International Labour Office.
- Rodrik, Dani (2006). The Social Cost of Foreign Exchange Reserves. NBER Working Paper No. 11952. Cambridge, MA: National Bureau of Economic Research.
- Santos, Alvaro (2009). Labor Flexibility, Legal Reform, and Economic Development. *Virginia Journal of International Law*, vol. 50, No. 1, pp. 43-106.
- Standing, Guy (2011). *The Precariat: The New Dangerous Class*. New York: Bloomsbury.
- Strayer, Paul (1950). The Council of Economic Advisers: Political Economy on Trial. *American Economic Review*, vol. 40, No. 2, pp. 144-154.
- Trujillo, Lourdes, Noelia Martin, Antonio Estache and Javier Campos (2002). Macroeconomic Effects of Private Sector Participation in Latin America's Infrastructure. Policy Research Working Paper 2906. Washington, D.C.: World Bank.
- United Nations (2007). *Report on the World Social Situation 2007: Employment Imperative*. New York: United Nations. Sales No. E.07.IV.9.
- United Nations Conference on Trade and Development (2011). *Trade and Development Report 2011*. Geneva: United Nations Conference on Trade and Development.
- World Bank (2002). *Globalization, Growth and Poverty: Building an Inclusive World Economy*. New York: Oxford University Press, for the World Bank.
- _____ (2005). *Economic Growth in the 1990s: Learning from a Decade of Reform*. Washington, D.C.: World Bank.
- _____ (2009). How Should Labor Market Policy Respond to the Financial Crisis?. HD and PREM Labor Market Teams. Washington, D.C.: World Bank. April.
- _____ (2012). *World Development Report 2013: Jobs*. Washington, D.C.: World Bank.

Chapter 7

Macroeconomic policy after the global recession of 2008-2009: a development perspective

IYANATUL ISLAM³⁷

Introduction: the limits of the standard macroeconomic framework

The standard macroeconomic framework assigns a central role to macroeconomic stability as a prerequisite for economic growth. It gained prominence in the case of developing countries during the structural adjustment era of the 1980s and 1990s. Over that period, 149 adjustment lending programmes were initiated on average per annum by the Bretton Woods institutions. In some cases, these programmes were highly persistent.³⁸ The structural adjustment era formally came to an end in 1998. Structural adjustment programmes were replaced by poverty reduction strategies (PRSs), but the focus on macroeconomic stability remained intact.

Macroeconomic stability is usually assessed in terms of the ability of countries to attain and sustain preferred nominal targets (whether implicit or explicit) pertaining to debts, deficits and inflation. The rationale is that predictability in terms of key nominal targets engenders market confidence, boosts investment, propels growth, and supports employment creation and poverty reduction. In principle, these nominal targets should be tailored to country-specific circumstances, but in practice they have often become part of a “one-size-fits-all” approach. Thus, in the case of inflation, the target suggested by the International Monetary Fund (IMF) for developing countries is usually less than 5 per cent, while for debt-to-gross domestic product (GDP) ratios the prudential thresholds are set at 40 per cent,

37 For queries on this chapter, please contact islami@ilo.org.

38 As Easterly (2003, p. 379) puts it “Adjustment lending has been so continuous for some economies that it is hard to speak of it as purely a transitional phenomenon.”

despite the fact that they do not seem to be anchored in robust empirical evidence (International Monetary Fund, 2007a; Goldsbrough, Adovor and Elberger, 2007). Maintaining foreign exchange reserves worth at least three months of import coverage is also a popularly cited threshold for monitoring the sustainability of current account deficits.

There is a well-established body of evidence that the relationship between macroeconomic stability and growth is asymmetric. Extreme instability—such as hyperinflation and out-of-control budget deficits—kills growth, but it does not follow that restoration of stability will be sufficient to promote self-sustaining growth and lead to durable and productive job creation (Zagha, Nankani and Gill, 2006). Indeed, it is possible for a country to be judged a major macroeconomic success story, but this can coexist with significant incidence of poverty and vulnerability, high inequality, inadequate structural transformation and modest employment and labour market outcomes. Hence, a rethinking of the standard macroeconomic framework is under way, a process in which leading IMF economists themselves are playing an important role (Blanchard and others, 2012). Such re-thinking appeared to receive a boost in the wake of the global recession of 2008-2009 that was unleashed by the United States-centred financial crisis of 2007. Yet, the global macroeconomic policy discourse is poised at a delicate juncture. The shift from fighting a worldwide recession with macroeconomic stimulus packages to a fiscal austerity agenda between 2009 and 2010—particularly pronounced in the European Union (EU)—has raised concerns among many commentators of reverting to a “business as usual” mode (Farrel and Quiggin, 2012).

From the perspective of developing countries, the primacy of the fiscal austerity agenda does not augur well. It means the continued dominance of the standard macroeconomic framework, despite its well-known limitations. Indeed, a review of 2009-2010 IMF Article IV Consultations—a traditional instrument through which macroeconomic policy advice is dispensed to developing countries—for a sample of 50 low- and middle-income countries suggests a preoccupation with fiscal consolidation and inflation control and insufficient attention to poverty reduction, employment creation and social protection (Islam and others, 2012). This is consistent with the advice proffered by the Bretton Woods institutions in their *Global Monitoring Reports* of 2010 and 2011. Despite this, there are some signs that the IMF is striving to develop “new generation” article IVs that will focus a lot more on the development and employment dimensions of macroeconomic policy advice.³⁹

Given the fact that the global discourse on macroeconomic policy is poised at a critical juncture, this chapter seeks to make a contribution to the discourse by suggesting how the standard macroeconomic framework can be made

39 An IMF Press Release notes that the organization is committed to strengthening its policy advice on “various aspects of employment and growth” (International Monetary Fund, 2012).

development-friendly. This will mean that macroeconomic policy managers in developing countries will have to eschew the “single mandate” that they have inherited from the structural adjustment era, refrain from succumbing to the EU-led siren song of fiscal consolidation at all costs and move to a “dual mandate” in which Governments have to play the delicate balancing act of being guardians of stability while promoting their role as active agents of development. This will necessitate significant reconceptualization, but by no means a radical overhaul, of orthodoxies pertaining to monetary policy, fiscal policy, exchange rate regimes and capital account management.

Monetary policy: going beyond a preoccupation with low, single-digit inflation targets⁴⁰

A core element of the mainstream macroeconomic framework is the role that is assigned to monetary policy. Ever since New Zealand adopted an inflation-targeting framework in 1990, it has become *de rigueur* among most orthodox economists to regard this as a best practice approach. Thus, the primary role of the central bank, both in developing and developed countries, is to foster price stability within a medium-term framework by pursuing low, single-digit inflation using the interest rate as a key policy instrument. This in turn is expected to promote policy credibility and to support growth.

Presently, 44 countries around the world have adopted explicit inflation targets. Eighteen are emerging and developing countries. The median inflation target of these 18 countries is 3.5 per cent. Excluding the countries in transition—Armenia, the Czech Republic, Hungary, Poland, Romania and Serbia—there are 12 developing countries, with a median inflation target of 4.25 per cent (Anwar and Islam, 2011).

How were these inflation targets set? Are they anchored in the historical experience of developing countries or on robust empirical evidence? It appears that the inflation targets that are set for emerging economies and developing countries are well below the long-run inflation rate observed in developing countries, on average, during the period (1961-2009, excluding the very high inflation episode of 1989-1995) and, in many cases, below the actual inflation rate of the 2000s. The inflation targets that are set do not take account of non-linearities in the growth–inflation relationship, that is, there is a threshold below which inflation has a positive impact on growth, while above this threshold inflation has a negative effect on growth.

The existence of a threshold effect in the growth-inflation relationship should be taken into account when setting inflation targets. Based on an analysis of 19 studies, the threshold effects for the developing world, that is, the values under which inflation has proven no negative impact on growth, vary from 11 per cent to

40 This section draws on Anwar and Islam (2011) and Islam and others (2012).

40 per cent in cross-section estimates and from 6 per cent to 11 per cent in country-specific estimates. Hence, from this perspective, the median targeted inflation rate for the 12 developing economies of 4.25 per cent appears to be too low in the sense that it might impose opportunity costs in the form of forgone growth. One should also note that the growth–inflation trade-off itself appears to have changed over time, with data from the 2000s suggesting a positive relationship between inflation and growth. This is unlike previous decades when the growth–inflation relationship was negative, but even this negative trend is sensitive to the presence of outliers. In addition, when a comparison is made between a group of inflation-targeting and non-inflation-targeting countries at similar levels of income and human development, inflation-targeting countries do not exhibit better employment and labour market outcomes than their non-inflation-targeting counterparts (Anwar and Islam, 2011).

One of the expected benefits of an inflation-targeting regime is that it generates a premium for the private sector by reducing inflation risks. This should then lead to reduced costs of borrowing, which should in turn spur private sector investment. Unfortunately, this does not seem to be the case as the available evidence shows that the median cost of borrowing in many developing countries has either remained at elevated levels or gone up in the 2000s (a period of low inflation) relative to previous decades.

One reason why borrowing costs may not come down to capture the premium of reduced inflation risks is that such costs might be determined largely by structural factors. It is likely that in many developing countries, the banking system is dominated by a few large financial (and multinational) institutions. Such market imperfections might mean that the premium of reduced inflation risks is being largely captured by these institutions rather than being passed on to borrowers in the form of lower cost of credit. These market imperfections are likely to be compounded by the weak institutional and legal environment prevailing in many developing countries. Inflation-targeting regimes—however flexible and effective—cannot deal with these structural issues and hence are limited in their capacity to make a major contribution to employment creation (Anwar and Islam, 2011).

Perhaps the biggest challenge of pursuing low, single-digit inflation targets for developing countries in the current global climate is the challenge of tackling food price inflation. The correlation coefficient between median inflation rates in low-income countries (LICs) and a global food price index is highly significant, that is, there is a statistically significant positive co-movement between domestic inflation and a global food price index.⁴¹ One estimate suggests that about 44 million people might have been pushed into at least a transient episode of poverty as a result of high and rising food prices (World Bank, 2012; Asian Development Bank, 2011). In July 2012, the World Bank’s global food price index reached

41 Authors’ estimates. The correlation coefficient is 0.8.

its highest level. Unfortunately, an inflation-targeting regime that relies heavily on using the interest rate to foster price stability is not really designed to deal with food price inflation. Not surprisingly, the Bretton Woods institutions take a circumspect view in dealing with inflationary pressures in the current global environment. Thus, in the case of the LICs, the 2011 *Global Monitoring Report* (International Monetary Fund and World Bank, 2011, p. 64) offers the following advice:

Most low income countries must closely monitor the effects of commodity prices on their domestic inflation rates, given risks associated with rising world prices for food and fuel. If these global shocks persist and feed through to local prices, monetary policy should accommodate the direct impact; however it may need to be tightened in some cases to counter second round effects.

In light of such concerns of the limitations of a strict adherence to low, single-digit inflation targets, what should the appropriate role of monetary policy be? One approach would be to resurrect an idea that is embedded in the founding principles of the IMF Article IV Agreements. This is where member States are exhorted to pursue the goal of “reasonable price stability” with due regard to country-specific circumstances and with the aim of sustaining “orderly” growth. This is a formulation that is far more flexible than recent tendencies to focus on low, single inflation targets that are applicable to large groups of countries.

A major challenge for monetary policy in LICs is to find ways of reducing the cost of borrowing and promoting financial inclusion. This means taking account of the extent to which lack of access to finance acts as a binding constraint on growth. Private sector firms in developing countries usually regard lack of access to finance as a major impediment to business operations and their employment-creating potential (International Finance Corporation and the World Bank, 2011). Hence, central banks and financial authorities have an obligation to enhance financial inclusion without forsaking their prudential obligations and their role in safeguarding price stability. Enhancing financial inclusion means (a) increasing access to finance for the private sector, especially small and medium-size firms, and (b) encouraging the development of well-regulated and efficient microfinance institutions (MFIs) that can respond to the financing needs of poor and vulnerable households that seek durable self-employment. Of course, even the pursuit of a well-designed financial inclusion agenda will not, on its own, be sufficient to sustain productive job creation. Complementary initiatives are required ranging across various policy spheres. The rest of the discussion is devoted to an examination of these complementary initiatives.

Fiscal policy: going beyond prudential targets on debts and deficits⁴²

Should developing countries focus on particular targets when designing fiscal policy? In its 2005 review of macroeconomic policy design for 15 LICs with access to concessional lending that were classified as “mature stabilizers”,⁴³ the IMF noted that several studies showed that the “level at which deficit reduction no longer boosts growth ranges between 1.5 per cent and 2.5 per cent, although it acknowledged that these estimates were ‘subject to considerable uncertainty’” (International Monetary Fund, 2005, p. 40). The 2005 report also pointed out that the observed average deficit was 4.5 per cent of GDP for the countries under review, but it did not see the benefits from further fiscal consolidation. Hence, one can infer that an average fiscal deficit of 4.5 per cent of GDP was deemed appropriate for LICs.

Is such a norm being used in assessing the conditions of today? A more stringent limit seems to be implicit in the *2010 Global Monitoring Report*. For example, the average fiscal deficit of developing countries is projected to expand from approximately 1.5 per cent of GDP in 2008 to 4.5 per cent of GDP in 2010 (International Monetary Fund and World Bank, 2010, p. 79). Yet, this expansion is deemed to be unsustainable in many cases. Hence, the implication is that developing countries as a group should aim for fiscal deficits that are closer to the levels that prevailed in 2008 (less than 2 per cent of GDP).

On prudential thresholds pertaining to public debt, the IMF is more explicit in its guidance. A 2002 report noted that, for developing economies, a 40 per cent debt-to-GDP ratio should be used as a prudential threshold when monitoring the sustainability of external borrowing (International Monetary Fund, 2002). A 2010 report issued by the Fiscal Affairs Department used this threshold to offer illustrative examples of the extent of fiscal adjustment that would be required for developing countries to stabilize the debt-to-GDP ratio by 2030 (International Monetary Fund, 2010a).

Of course, one can raise questions about the empirical robustness of the prudential thresholds on public debt that are being used for policy guidance. Studies on the public debt–growth link suggest that the level at which public debt harms growth in developing countries and emerging market economies ranges from 20 per cent of GDP to 90 per cent of GDP (Chowdhury and Islam, 2012). Furthermore, the relationship between initial debt-to-GDP ratio and subsequent growth for developing economies is weak. The “slope” in the “line of best fit” is rather shallow. For example, one study (Kumar and Woo, 2010, p. 4) that served as a key input in the IMF 2010 Fiscal Monitor notes that “a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a slowdown in annual

42 This section draws on Islam and others (2012), and Islam and Anwar (2011).

43 The moniker “mature stabilizers” refers to countries that have managed to consolidate macroeconomic stability.

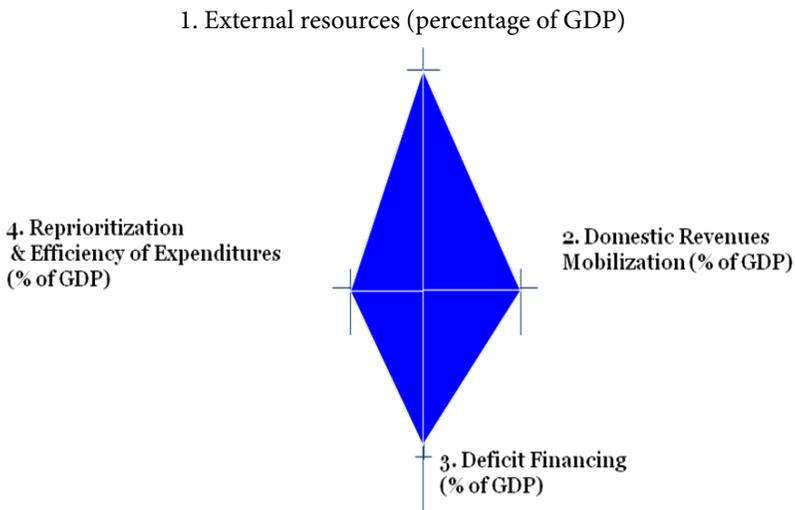
real per capita GDP growth of around 0.2 percentage points per year”. One also infers from this study an important point that is not emphasized by the authors. Even a modest negative effect of debt on growth can be easily offset by other variables that promote growth (such as schooling) which, in the aforementioned study, has a positive and statistically significant coefficient that is substantially larger in magnitude than the coefficient on public debt.

If recent proclivities to focus on fiscal targets, and the growing popularity of fiscal rules that are anchored in these targets, are not necessarily based on robust empirical evidence, what can one advocate as an alternative approach? (International Monetary Fund, 2009). The role of fiscal policy in a development context is twofold. First, one should focus on long-term financing needs engendered by an appropriate conceptualization of core development goals. Second, one should highlight the countercyclical role that fiscal policy can play.

Robust and regular estimates are required to assess the financing needs associated with meeting core development goals. Such goals might be nationally adapted versions of the Millennium Development Goals (MDGs) of 2000 and their amended version in 2008, and the Social Protection Floor (SPF) Initiative as adopted by the United Nations system in 2009. An illustration of such estimates is shown in box 7.1. The message is that there are conspicuous and unmet financing needs.

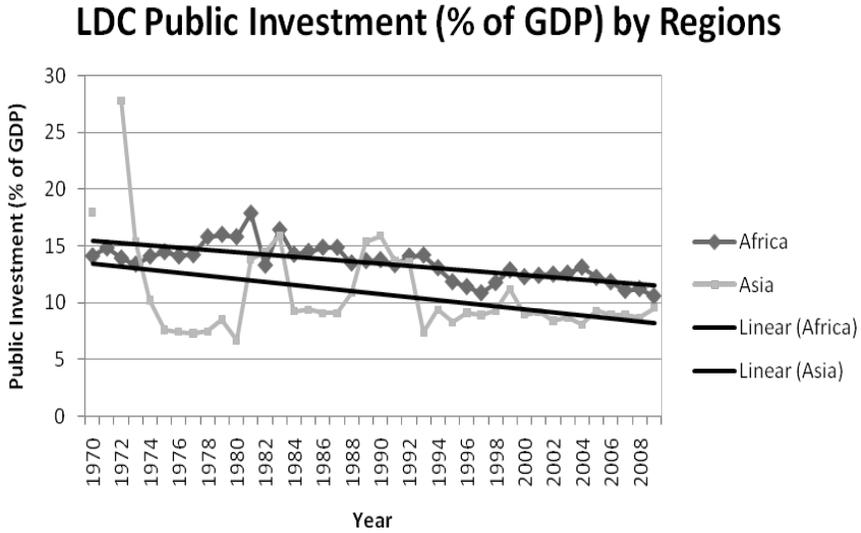
Once evaluations of financing needs are done, the next step is to identify a country’s “fiscal diamond” as shown in figure 7.1. The fiscal diamond is a compact, but critical, summary of the way one can increase fiscal space to meet the

Figure 7.1 The “fiscal diamond” (percentage of GDP)



Source: Author’s adaptation from the International Monetary Fund–World Bank Development Committee (2006).

Figure 7.2 Public investment in LDCs, Africa and Asia, 1970-2008 (percentage of GDP)



Source: World Development Indicators, World Bank (2010). Available from <http://data.worldbank.org/data-catalog/world-development-indicators/wdi-2010>.

core development goals. This entails mobilizing domestic and external resources within a framework of fiscal sustainability to support enhanced public investment in health, education, water supply, sanitation and infrastructure—all critical in attaining the MDGs. This needs to be combined with sustained efforts to harness resources to finance an SPF that includes such targeted interventions as public employment programmes.

It is well known that there has been a secular decline in public investment in the developing world, most notably in the least developed countries (LDCs) as shown in figure 7.2. What is the scale of the public investment challenge facing LDCs? The Commission on Growth and Development (2008) suggests that a public investment rate in infrastructure of around 7 per cent of GDP is needed as an important element of a national development strategy. Yet, the data suggests that barely 2 to 3 per cent of GDP is invested in infrastructure in many developing countries and emerging economies. This is clearly a policy challenge, given that 50 per cent of enterprises in Asia and Africa cite lack of access to electricity as a major constraint on their business operations (International Finance Corporation and the World Bank, 2011).

Addressing these concerns requires determined public action to cope with the public investment deficit that has built up over decades. Hence, a resource mobilization strategy pursued through improved budgetary execution and enhanced domestic revenue-to-GDP ratios in countries with a low tax burden

Box 7.1

Financing the Millennium Development Goals and the Social Protection Floor

In 2002, the World Bank estimated that, if countries improved their policies and institutions, the additional foreign aid required to attain the MDGs by 2015 would be between US\$ 40 and US\$ 60 billion a year (Devarajan, Miller and Swanson, 2002) and the Asian Development Bank (ADB) estimates the additional per person costs for the poverty income goal to be between US\$ 550 and US\$ 880 (Markandya and others, 2010). To meet these per capita costs, foreign aid commitments would have to be twice their current projected size.

A forerunner to the SPF is the 'basic social security package' that was proposed by the ILO in 2008. Such a package includes the following elements: (a) basic old-age and disability pensions (benefits set at the rate of 30 per cent of GDP); (b) benefits at the rate of 15 per cent of GDP for the first two children below the age of 14; (c) 100 days guaranteed employment at a wage of 30 per cent of per capita GDP for a maximum of 10 per cent of all people of all ages; and (d) essential health care based on one health professional per 300 persons. Using these benchmarks, the study examined 12 countries, out of which seven are in Africa (Burkina Faso, Cameroon, Ethiopia, Guinea, Kenya, Senegal, United Republic of Tanzania) and the rest in Asia (Bangladesh, India, Nepal, Pakistan and Viet Nam), using projections for the period 2010–2030. The fiscal requirements range from over 10 per cent of GDP (Burkina Faso) to a little over 4 per cent (Guinea).

The fiscal challenges of meeting the MDGs and the SPF in the wake of the Great Recession are brought out by an OXFAM study. It shows that the global recession of 2008-2009 has created a huge 'fiscal hole' in the 56 LICs, by reducing their budget revenues (and their ability to spend to confront the crisis and reach the MDGs) by \$65 billion over the 2009–2010 period (Kyrili and Martin, 2010). As a result of the fiscal hole and following some fiscal stimulus to combat the crisis in 2009, most LICs are cutting MDG spending, especially on education and social protection.

Source: Author's adaptation from the International Monetary Fund – World Bank Development Committee (2006).

are core planks of a development strategy (International Monetary Fund, 2009; United Nations Development Programme, 2010; United Nations Conference on Trade and Development, 2010). For example, estimates show that the Bangladesh Government can fully upgrade its public employment programme to an Indian standard national employment guarantee scheme by increasing its historically low tax-to-GDP ratio by 3 percentage points and by better utilizing its existing resources (Islam, Mujeri and Ali, 2011). This can be complemented by other initiatives, such as public–private partnerships and efforts to tap domestic savings and channel them into productive investment. In addition, where energy taxation can be used effectively and equitably, it can become a new source of revenue that has the benefit of supporting initiatives to cope with climate change.

Domestic resource mobilization needs to be supported by enhanced development assistance from donors. Hence, maintaining aid commitments and exploring feasible options for identifying alternative sources of reliable and low-cost development finance to supplement traditional sources are important elements of a development-friendly macroeconomic framework.

As part of enhanced development assistance, an important issue is the role that debt relief has played in enhancing fiscal space for developing countries, as shown in box 7.2. While debt relief in aggregate has contributed to enhancing fiscal space, country-specific experiences suggest that there is significant scope for improvement.

As noted, fiscal policy has an important role to play in stabilizing business cycles. This was once regarded as part of the conventional wisdom, but was superseded by the preoccupation with using monetary policy within an inflation-targeting framework that emerged during the 1990s. At the same time, the need to attain fiscal discipline as a means of boosting investor confidence came to the fore of policy priorities. As a result, the role of fiscal policy in smoothing business cycles fell into a state of benign neglect. The global recession of 2008-2009, and the fiscal stimulus packages that emerged across the world to cope with the consequences of the recession, has led to renewed attention to the countercyclical role of fiscal policy. Of course, if a developing country is laden with high debts and deficits, and if the institutional capacity does not exist to design and implement countercyclical policy, then using fiscal measures in this way is not feasible. Hence, the advice offered now is that developing countries need to use the normal periods of growth and boom times to build up resources that can be set aside in purpose-built stabilization funds that can be tapped to cope with aggregate demand shocks. At the same time, investments need to be made in developing automatic stabilizers (such as employment guarantee schemes and conditional cash transfers) that can come into play during a recession. The evidence clearly suggests that procyclical policies are deleterious from a development perspective.

Exchange rate and capital account management: aiming for competitive and stable real exchange rates and coping with capital flows

A perennial issue in the case of designing exchange rate regimes that are conducive to core development goals is the extent to which one should aim for either floating or fixed exchange rate regimes. It used to be fashionable to suggest that developing countries should adopt “corner solutions”, that is, either fixed or floating exchange rate regimes. The “corner solutions” approach does not obviate painful trade-offs between stability and development objectives that a given exchange rate regime might entail. For example, a fixed exchange rate regime—and stronger versions, such as “dollarization” schemes and currency

boards—might provide stability through a reliable nominal anchor, but will rob countries of crucial policy autonomy. Moreover, it will then not be possible to use the exchange rate as a key instrument for fostering structural transformation by influencing resource allocation between traded and non-traded sectors (Krueger, 1997).

What can one prescribe as an appropriate exchange rate regime? One possibility is the adoption of institutional arrangements that sustain competitive and stable real exchange rates, given the evidence that the real exchange rate—and even a protracted period of modest undervaluation—exerts a powerful influence on structural transformation (McMillan and Rodrik, 2011). A study on sub-Saharan Africa using data for the period 1970-2004 shows that real exchange rate overvaluation reduces growth and impedes export diversification (Elbadawi,

Box 7.2

The relationship between debt relief and fiscal space in LDCs

According to the IMF's African Department Director, the fiscal space created by high levels of debt relief is supporting poverty-reducing spending in LDCs (International Monetary Fund, 2007b). Initiatives such as the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief Initiative (MDRI) have substantially reduced the debt-to-GDP and debt-to-export ratios of a significant subset of countries in the LDC group, improving the overall sustainability of their debt and freeing considerable amounts of resources that were previously earmarked for debt servicing (United Nations Conference on Trade and Development, 2010).

The trends indicate that the level of debt relief for LDCs spiked at a high level from 2005 to 2006, following the Gleneagles Summit, but swiftly came down in 2007. Total debt service steadily declined from above 20 per cent of total exports to less than 5 per cent in 2008. However, this progress does not mean that the debt issue is no longer relevant in LDCs. As of April 2010, 14 LDCs which still remained in debt distress or at high risk of debt distress were not identified as HIPCs or had not reached the completion point. Even in the best-case scenario of a fast recovery and a long-term growth path, LDCs and developing countries alike will face higher debt burdens as a result of the global economic crisis.

The relationship between debt relief and fiscal space differs across LDCs. The fiscal space assessments for Malawi and Mozambique noted that debt relief under the HIPC Initiative had expanded fiscal space and thereby allowed for a scaling up of public investments (United Nations Development Programme, 2010). The MDG Report for Malawi noted that with 84 per cent of the country's external debt stock cancelled, the country's annual debt service had been reduced to US\$15 million, freeing up US\$110 million for expenditures in priority programmes. However, one country study, using the MDG framework to critically examine fiscal policies in Zambia, finds that the Zambian Government enjoys very little policy space and when all calculations are carried out and attendant conditionalities on policy-making are taken into account, HIPC debt relief actually provides marginally less fiscal space, rather than more (Weeks and McKinley, 2006).

Kaltani and Soto, 2008). As box 7.3 shows in the case of Malawi, moving towards a competitive and stable real exchange rate regime is an essential component of a pro-employment macroeconomic framework.

An issue closely related to the exchange rate regime is the management of the capital account. It used to be fashionable to argue that developing countries should aim for capital account liberalization as a major policy goal. Indeed, prior to the onset of the 1997 Asian financial crisis, a proposal was proffered by the international financial institutions (IFIs) that all member States belonging to such institutions should aim for an open capital account as an eventual goal. The pitfalls of this proposal were exposed by the experiences of the East Asian economies during the financial crisis of 1997. Some of them acquired unsustainable “liability dollarization” (that is, liabilities denominated in dollars, but assets denominated in local currency). When the quasi-fixed exchange rate system maintained by some East Asian economies collapsed as a result of sudden capital outflows caused by an abrupt shift in investor sentiments, the sharp devaluation that followed had a strong negative wealth effect on the balance sheet of the private sector. This triggered a balance-sheet recession (Islam and Chowdhury, 2001). Hence, it is now recognized that, in cases where unrestrained capital flows pose a policy challenge, a more prudent approach to capital account management might be justified, as this opens up policy space for initiatives that create employment and reduce poverty (Ostry and others, 2010).

Concluding remarks

The global discourse on macroeconomic policy is now poised at a critical juncture. On the one hand, a rethinking is under way in light of the realization that the standard macroeconomic framework, with its emphasis on fiscal discipline and inflation control, has its weaknesses in dealing with recessions, especially those engendered by large-scale external shocks. At the same time, the standard macroeconomic framework as it has evolved since the structural adjustment era of the 1980s and 1990s is insufficiently connected to core development concerns pertaining to poverty reduction, employment creation and social protection.

Despite such a momentum for rethinking macroeconomics, the shift from fighting a recession with stimulus packages to an EU-led fiscal austerity agenda between 2009-2010 has raised concerns among many commentators of a regression to a “business as usual” mode. This chapter has argued that developing country policymakers should not succumb to this “business as usual” mindset. This will entail the need to sustain the momentum on rethinking macroeconomics in a way that makes it development-friendly. This will in turn entail a significant reformulation, but by no means a radical overhaul, of prevailing orthodoxies in monetary policy, fiscal policy, exchange rate regimes and capital account management. The overarching idea is one of adopting a dual mandate in which

Box 7.3**Malawi: The exchange rate regime and its implications for growth and employment**

A study commissioned by the ILO shows that “macroeconomic policy, particularly exchange rate policy, matters a great deal” in affecting economic growth and employment creation. The study maintains that Malawi has a “tradition of attempting to maintain a stable nominal exchange rate, i.e., fixing the value of the Kwacha in terms of US dollars... The official purpose of maintaining a stable exchange rate is primarily to reduce inflation,” with the Government arguing that this anti-inflation dimension of exchange rate policy is worth preserving because export supply is not very responsive to the exchange rate. This might be true in the short term, but ignores the role that a competitive real exchange rate plays in supporting structural transformation in the medium term. The study shows that, given the higher inflation rate in Malawi relative to its trading partners, attempting to maintain a nominal exchange rate leads to a real appreciation and also induces volatility. There is also evidence that the real appreciation is associated with a sharp jump in import penetration from 44 per cent of GDP in 2007 to 53 per cent in 2008. The study urges policy-makers to recognize that with a competitive and predictable real exchange rate regime, “firms would most likely have created more jobs, invested more and diversified more in Malawi”

Source: ILO and Government of Malawi (2010: 84–87).

macroeconomic policy managers act as both guardians of stability and active agents of development. Getting the balance right between the two roles is a key policy challenge.

The chapter has argued that, within the framework of the dual mandate, policymakers in developing countries should aim for reasonable price stability that is sensitive to country-specific growth-inflation trade-offs, take account of food price inflation and seek to deal actively with the agenda of financial inclusion. Diligently practicing these ideas will entail a departure from the preoccupation with maintaining low, single-digit inflation as the sine qua non of monetary policy.

In the sphere of fiscal policy, the chapter has advocated the need for moving away from a focus on attaining predetermined targets pertaining to debts and deficits. Fiscal policy in a development context entails both long-term and short-term dimensions. In the long term, the aim should be a sustainable resource mobilization strategy that seeks to meet core development goals (such as nationally adapted MDGs and SPFs). In the short-term, fiscal policy has an important role to play by seeking to smooth business cycles. This entails restoring demand and thereby growth and employment in times of crisis. It will necessitate prior investments in institutional and funding capacities.

The chapter has also noted that the issue of an appropriate exchange rate is important in dealing with the challenges of structural transformation. The available evidence suggests that supporting a stable and competitive real exchange rate

regime might be effective in supporting the process of structural transformation. A related conclusion of the chapter is that prudent capital account management is an important ingredient of a development-friendly macroeconomic framework. It enables the preservation of policy autonomy and allows Governments to shield their citizens from the vagaries and volatility of short-term capital flows.

References

- Anwar, S., and I. Islam, (2011). Should developing countries target low, single digit inflation to promote growth and employment? Employment Working Paper No.87 (August), Geneva: International Labour Organization.
- Asian Development Bank (2011). *Global Food Price Inflation and Developing Asia*. Manila: Asian Development Bank. ISBN 978-92-9092-282-7.
- Blanchard, Olivier, David Romer, Michael Spence and Joseph Stiglitz (2012). *In the Wake of the Crisis: Leading Economists Reassess Economic Policy*. Cambridge: The MIT Press.
- Chowdhury, Anis, and Iyanatul Islam (2012). The Debate on Expansionary Fiscal Consolidation: How robust is the evidence? *The Economic and Labour Relations Review*, vol.23, No.3, pp.13-38.
- Commission on Growth and Development (2008). *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, pp. 30–35. Available from http://siteresources.worldbank.org/EXTPREMNET/Resources/489960-1338997241035/Growth_Commission_Final_Report.pdf.
- Devarajan, S., Margaret Miller and Eric Swanson (2002). Goals for development: History, prospects and costs. Policy Research Working Paper No. 2819. Washington, D.C.: World Bank.
- Elbadawi, Ibrahim, Linda Kaltani and Raimundo Soto (2008). Aid, real exchange rate misalignment and economic performance in Sub-Saharan Africa. Dubai Economic Research Institute, IMF and Universidad Catolica de Chile. Available from http://www.economia.puc.cl/docs/dt_368.pdf.
- Farrell, Henry, and John Quiggin (2012). Consensus, dissensus and economic ideas: the rise and fall of Keynesianism during the economic crisis. Mimeo. George Washington University and University of Queensland. 9 March. Available from <http://www.henryfarrell.net/Keynes.pdf>.
- Goldsbrough, David, Ehui Adovor and Ben Elberger (2007). Inflation targets in IMF-supported programs. Working Group on IMF Programs and Health Expenditures Background Paper. Washington, D.C.: Center for Global Development.
- International Finance Corporation and the World Bank (2011). Enterprise Surveys. Available from <http://www.enterprisesurveys.org/>
- International Labour Organisation/Government of Malawi, Ministry of Labour (2009) An Employment Diagnostic Analysis of Malawi. http://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_policy/---cepol/documents/publication/wcms_143247.pdf
- International Monetary Fund (2002). Assessing sustainability. Policy Develop-

ment and Review Department. Washington, D.C. 28 May.

____ (2005). Monetary and fiscal policy design issues in low-income countries. Washington, D.C. 8 August.

____ (2007a). *An Evaluation of the IMF and Aid to Sub-Saharan Africa*, Independent Evaluation Office of the IMF. Washington, D.C.

____ (2007b). Africa's better policies are paying off. Interview with Abdoulaye Bio-Tchane, IMF Survey Magazine. 28 June.

____ (2009). Fiscal rules: Anchoring expectations for sustainable public finances. Fiscal Affairs Department, December 16, Washington, D.C.

____ (2012). IMF work program focuses on restoring stability, growth, and jobs, Press Release No. 12/199. Available from <http://www.imf.org/external/np/sec/pr/2012/pr12199.htm>. 7 June 2012.

International Monetary Fund–World Bank Development Committee (2006).

Fiscal policy for growth and development: An interim report. Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries. DC2006-0003. 6 April 2006.

International Monetary Fund and World Bank (2010). *Global Monitoring Report 2010: The MDGs after the Crisis*. Washington, D.C.

____ (2011). *Global Monitoring Report 2011: Improving the Odds of Achieving the MDGs. Heterogeneity, Gaps and Challenges*. Washington, D.C.

Islam, Iyanatul, and Anis Chowdhury (2001). *The Political Economy of East Asia: Post-Crisis Debates*. Melbourne and Oxford: Oxford University Press.

Islam, Iyanatul, Ishraq Ahmed, Rathin Roy and Raquel Ramos (2012). Macro-economic Policy Advice and the Article IV Consultations: A Development Perspective, ILO Research Paper Series No.2. Geneva: International Labour Organization.

Islam, Iyanatul, and Sarah Anwar (2011). Post-crisis macroeconomics and the least developed countries: A way forward. *The Global Crisis: Causes, Responses and Challenges*. Geneva: International Labour Organization.

Islam, Rizwanul, Mustafa K. Mujeri and Zulfiqar Ali (2011). Fiscal and policy space for crisis response with a focus on employment and labour market: A study of Bangladesh. Employment Working Paper No.92. Geneva: International Labour Office.

Krueger, Anne (1997). Nominal anchor exchange rate policies as a domestic distortion. NBER Working Paper No. 5968. National Bureau of Economic Research.

- Kumar, Manmohan, and Jaejoon Woo (2010). Public debt and growth. IMF Working Paper, 10/174, pp.1-47. Washington, D.C.: International Monetary Fund.
- Kyrili, Katerina, and Matthew Martin (2010). The impact of the global economic crisis on the budgets of low-income countries. OXFAM Research Paper, commissioned by Oxfam from Development Finance International.
- Malawi, Government of (2010). *Employment diagnostic analysis on Malawi*. Ministry of Labour.
- Markandya, Anil, Sununtar Setboonsarng, QiaoYu Hui, Rachanee Songkranok and Adam Stefan (2010). The costs of achieving the Millennium Development Goals through adopting organic agriculture. ADBI Working Paper Series No. 193. Tokyo: Asian Development Bank Institute. Available from http://www.eaber.org/sites/default/files/documents/ADBI_Markandya_2010.pdf.
- McMillan, Margaret, and Dani Rodrik (2011). Globalization, structural change and productivity growth. *Making globalization socially sustainable*, Marc Bacchetta and Marion Jansen (eds.). Geneva: International Labour Office and World Trade Organization.
- Ostry, Jonathan D., Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahavash S. Qureshi and Dennis B.S. Reinhardt (2010). Capital inflows: The role of controls. IMF Staff Position Note No. 4. International Monetary Fund. Available from <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>.
- United Nations Conference on Trade and Development (2010). *The Least Developed Countries Report 2010: Towards a New International Development Architecture for LDCs*. United Nations publication. Sales No. E.10.II.D.5.
- United Nations Development Programme (2010). *Beyond the Midpoint: Achieving the Millennium Development Goals*. New York: United Nations Development Programme.
- Weeks, John, and Terry McKinley (2006). Does debt relief increase fiscal space in Zambia? The MDG implications. International Poverty Centre Country Study No.5. United Nations Development Programme.
- World Bank (2012). Food Price Watch, August. Available from <http://reliefweb.int/report/world/food-price-watch-august-2012>.
- Zagha, Roberto, Gobind Nankani and Indermit Gill (2006). Rethinking growth, *Finance and Development*, vol.43, No.1.

Chapter 8

The distributional effects of fiscal austerity

LAURENCE BALL, DAVIDE FURCERI, DANIEL LEIGH AND PRAKASH LOUNGANI⁴⁴

Introduction

Financial crises are typically associated not only with sharp economic downturns but also with a substantial deterioration of fiscal positions (Reinhart and Rogoff, 2009). Declining revenues owing to weaker economic conditions, higher expenditures associated with bailout costs and demand stimuli have historically led to a rapid deterioration of fiscal balances and a significant and long-lasting increase of public debt. In particular, looking at past historical episodes of severe financial crises, Furceri and Zdzienicka (2012) find that the debt-to-gross domestic product (GDP) ratio has typically increased by about 35 percentage points compared with pre-crisis trends, with the effect lasting for about 10 years.

Similarly, the Great Recession of 2007-2009 has led to a significant increase in public debt, in large part because of the collapse in tax revenues as incomes fell. Other contributors to the debt build-up were the costs of financial bailouts of banks and companies and the fiscal stimulus provided by many countries to stave off a Great Depression. All in all, in advanced economies public debt has increased from 70 per cent of GDP in 2007 to about 100 per cent of GDP in 2012—its highest level in 50 years (International Monetary Fund, 2013).

In the absence of significant consolidation measures, debt-to-GDP ratios in many advanced economies are likely to remain high over the medium term. In particular, based on the assumption that consolidation measures are only gradual but sufficient to stabilize the government debt-to-GDP over the medium term

44 Ball: Johns Hopkins University; Furceri, Leigh and Loungani: International Monetary Fund. We are grateful to Saurabh Mishra and Jair Rodriguez for excellent research assistance. The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy.

(Organization for Economic Cooperation and Development, 2011), debt-to-GDP ratios may still increase by about 30 percentage points by 2025 compared with pre-crisis levels. Moreover, looking ahead, population ageing could create even more serious problems for public finances.

Against this backdrop, many Governments are already undertaking or planning policies to reduce government debt and deficits, through a combination of spending and tax-based consolidation measures.

When British Prime Minister David Cameron announced his Government's deficit reduction plans in 2011 at Davos, he said *"Those who argue that dealing with our deficit and promoting growth are somehow alternatives are wrong. You cannot put off the first in order to promote the second."* (Cameron, 2011). The challenge facing the United Kingdom of Great Britain and Northern Ireland and many advanced economies is how to bring debt down to safer levels in the face of a weak recovery. Will deficit reduction lead to stronger growth and job creation in the short run? What will be the distributional consequences?

While the effects of fiscal consolidation on output and unemployment have been extensively investigated in the literature,⁴⁵ up to now, only a few studies have looked at their distributional effects. The empirical evidence reported in these studies suggests that fiscal consolidation measures: (a) are typically associated with an increase in poverty and a rise in the income gap (Smeeding, 2000); (b) affect the trade-off between economic growth and income inequality (Mulas-Granados, 2005); and (c) increase income inequality (Agnello and Sousa, 2012; International Monetary Fund, 2012).

The aim of this chapter is to contribute to the literature on this topic and assess the short- and medium-term distributional effects of fiscal austerity. For this purpose, the chapter considers past historical episodes of fiscal consolidation to estimate impulse response functions (IRFs) of fiscal consolidation episodes on income inequality (proxied by the Gini coefficient) and on different types of income.

Using past episodes of fiscal consolidation measures for a sample of 17 Organization for Economic Cooperation and Development (OECD) countries over the period 1978-2009, the results of the chapter suggest that fiscal consolidation episodes have typically led to a significant and long-lasting increase in inequality. Differentiating between spending- versus tax-based consolidation episodes, the results suggest that the latter tend to have a more persistent effect. The empirical evidence presented in the chapter also show that while fiscal consolidation measures have typically led to a fall in wage income, they have not had a significant effect on profit and rent income.

The rest of the chapter is organized as follows. The next section describes the data and presents some descriptive statistics. The section following presents the empirical methodology used to examine the effects of fiscal consolidation

45 See, for example, Alesina and Perotti (1995, 1997), Alesina and Ardagna (2010), Broadbent and Daly (2010), and Guajardo, Leigh and Pescatori (2011).

episodes on income inequality and on different types of income. The penultimate section describes the results. And, finally, the chapter concludes with the main findings and policy implications.

Data

Inequality

The dependent variable in our regression is the Gini coefficient for disposable income. Our main source for the data is the Standardized World Income Inequality Database (SWIID) (Solt, 2011; 2009).

Focusing on the subsample of advanced economies covered in the empirical analysis, it can be noted that the Gini coefficient varies considerably across countries, ranging from more than 35 in Italy, Portugal and the United States of America to less than 25 in Denmark and Sweden (see figure 8.1). Inequality has increased almost everywhere, with Italy, Japan, Portugal and the United States recording the largest increase.

Up to now, the evolution of inequality does not seem to have been affected by the global crisis (Jenkins and others, 2011). In particular, changes in inequality have varied among both those worst hit by the crisis—with point estimates of the Gini increasing in Latvia and Lithuania but falling in Estonia, Greece and Iceland from 2007 to 2010—and among those economies that experienced smaller contraction in economic activity (the Gini increased in France and Spain but fell in the Netherlands and Portugal).⁴⁶ However, previous empirical evidence shows that distributional effects of crises can take many years before they materialize (Atkinson and Morelli, 2011), suggesting that it may be still too early to predict what the distributional consequences of the recent global recession will be.

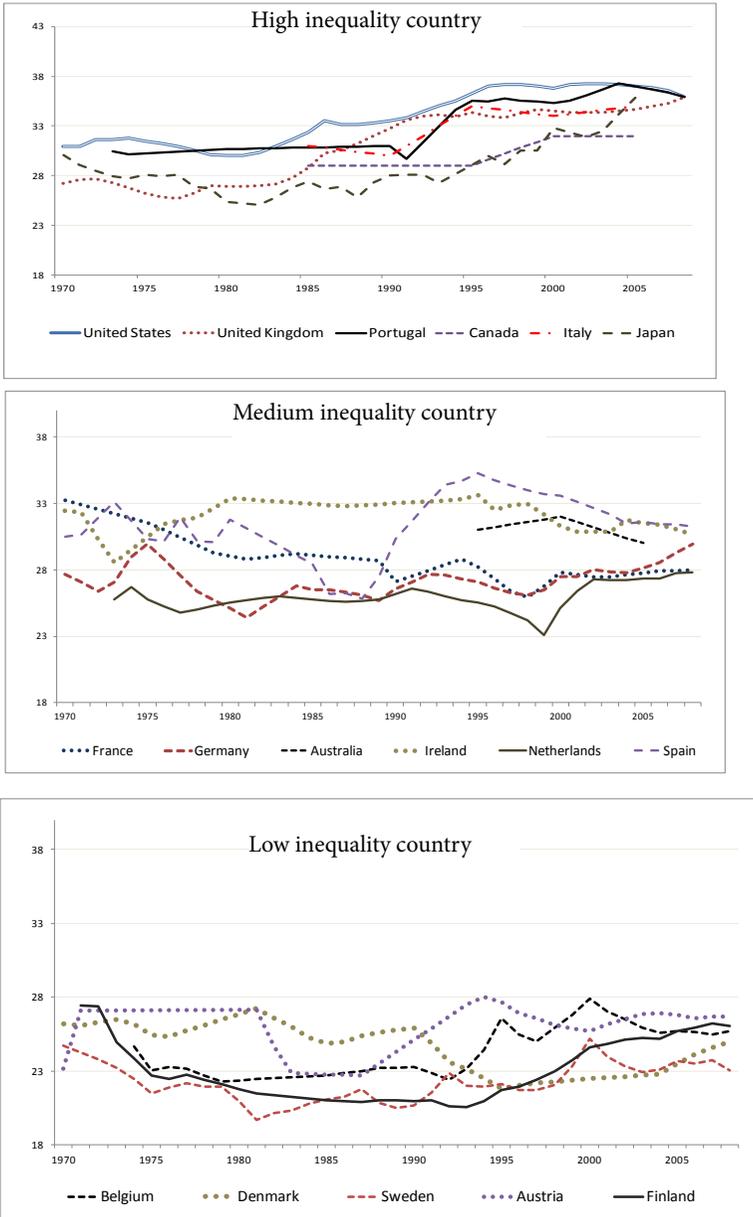
Fiscal consolidation episodes

Fiscal consolidation episodes are taken from Devries and others (2011) database. The database contains information on 173 episodes of fiscal consolidation for 17 OECD economies (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Portugal, Spain, Sweden, the United Kingdom and the United States) during 1978-2009. The magnitude of the fiscal consolidation episode ranges between 0.1 per cent and about 5.0 per cent of GDP, with an average of about 1 per cent of GDP.

The measure of fiscal consolidation constructed by the authors is based on a narrative approach and focuses on *policy* actions—tax hikes and/or spending cuts—taken by Governments with the intent of reducing the budget deficit. This approach differs from previous studies in the literature in which fiscal consolidation

46 These results have to be treated with caution given the large standard errors associated with the Gini point estimates.

Figure 8.1. Gini coefficient in advanced economies



Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009).

is measured by successful budget *outcomes* (e.g., Giavazzi and Pagano, 1990; Alesina and Ardagna, 2010). Specifically, the cyclically adjusted primary balance (CAPB)—the primary balance adjusted for the estimated effects of business cycle fluctuations—is used as a measure of fiscal consolidation. The cyclical adjustment is needed because tax revenue and government spending move automatically with the business cycle. The hope is that, after this cyclical adjustment, changes in fiscal variables reflect policymakers' decisions to change tax rates and spending levels. An increase in the CAPB would therefore, in principle, reflect a deliberate policy decision to cut the deficit.

In practice, however, budget outcomes turn out to be an imperfect measure of policy intent. One problem is that the cyclical adjustment suffers from measurement errors. In particular, it fails to remove swings in government tax revenue associated with asset price or commodity price movements from the fiscal data, resulting in changes in the CAPB that are not necessarily linked to actual policy changes. For example, in the case of Ireland in 2009, the collapse in stock and housing prices induced a sharp reduction in the CAPB, despite the implementation of tax hikes and spending cuts exceeding 4.5 per cent of GDP.

Another problem is that the standard approach ignores the motivation behind fiscal actions. Thus, it includes years in which Governments deliberately tightened policy to restrain excessive domestic demand. For example, in Finland in 2000, there was an asset price boom and rapid growth, and the Government decided to cut spending to reduce the risk of economic overheating. If a fiscal tightening is a *response* to domestic demand pressures, it is not valid for estimating the short-term effects of fiscal policy on economic activity, even if it is associated with a sharp rise in the CAPB.

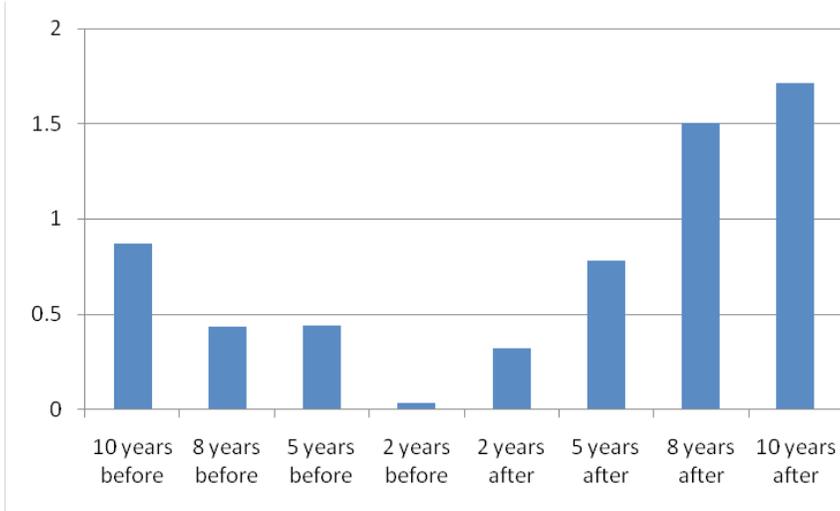
It transpires that these problems with the CAPB bias the analysis towards downplaying contractionary effects and overstating expansionary ones. It tends to select periods associated with favourable growth outcomes but during which no austerity measures were actually taken. It also tends to omit cases of fiscal austerity associated with unfavourable growth outcomes.

Inequality and fiscal consolidation

While the impact of fiscal adjustments on income disparities varies substantially across countries (Agnello and Sousa, 2012), there is a reasonably large number of countries in which fiscal consolidation has triggered an increase in inequality (e.g., Finland, Italy and Spain in the 1990s, or Germany, Japan and Portugal in the 1980s). On average, however, past episodes of fiscal adjustments seems to be associated with a sizeable increase in income inequality. In particular, looking at cumulative changes in the Gini coefficient before and after the beginning of a consolidation episode (figure 8.2), it emerges that fiscal consolidation episodes, on average, have been typically associated with an increase in the Gini of about 0.3 percentage points in the short term (two years after the occurrence of a

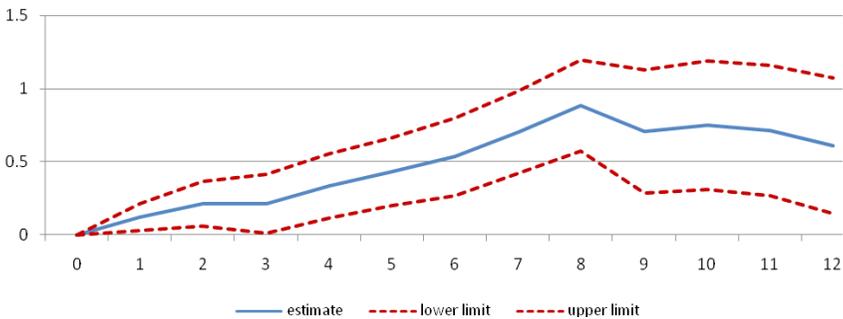
Note: High inequality is defined as countries with Gini coefficient above 32 in latest period available, Medium as countries with Gini above 27 but less than 32, and low for countries with Gini coefficient of less than 27.

Figure 8.2. Cumulative change in the Gini coefficient before and after consolidation measures



Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009). (Authors calculations)

Figure 8.3. The effects of fiscal consolidation on inequality



Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009). (Authors calculations).

consolidation episode) and of about 1.7 percentage points in the medium term (10 years after the occurrence of a consolidation episode). Inferential analysis on the dynamic effect of fiscal consolidation on income inequality will be presented in the following sections.

Empirical methodology

In order to assess the distributional impact of fiscal consolidation episodes over the short and medium terms, the chapter follows the method proposed by Jorda (2005), which consists of estimating the dynamic change in inequality in the aftermath of fiscal adjustment episodes. In detail, for each future year, k , the following equation has been estimated on annual data:

$$(1) \quad G_{i,t+k} - G_{i,t} = \alpha_i^k + Time_t^k + \sum_{j=1}^l \gamma_j^k \Delta G_{i,t-j} + \beta_k D_{i,t} + \varepsilon_{i,t}^k$$

with $k = 1, \dots, 8$. Where G represents our measure of inequality (proxied by the Gini coefficient for disposable income); $D_{i,t}$ is a dummy variable that takes the value equal to 1 for the starting date of a consolidation episode in country i at time t and 0 otherwise; α_i^k are country fixed effects; $Time_t^k$ is a time trend; and β_k measures the impact of fiscal consolidation episodes on the change of the Gini coefficient for each future period k . Since fixed effects are included in the regression, the dynamic impact of consolidation episodes should be interpreted as changes in the Gini coefficient compared to a baseline country-specific trend. The number of lags (l) has been chosen to equal two, as this produces the best specification, but the results are extremely robust with respect to different numbers of lags included in the specification (see robustness checks presented in the next section). Equation (1) is estimated using the panel-corrected standard error (PCSE) estimator (Beck and Katz, 1995).⁴⁷

The dynamic response of inequality to fiscal adjustments are then obtained by plotting the estimated β_k for $k = 0, 1, \dots, 8$, with confidence bands for the estimated effects being computed using the standard deviations associated with the estimated coefficients β_k . While the presence of a lagged dependent variable and country fixed effects may in principle bias the estimation of γ_j^k and β_k in small samples the length of the time dimension mitigates this concern.⁴⁸

Reverse causality is addressed by estimating changes in the Gini coefficient in the years that *follow* a fiscal consolidation episode. In addition, robustness checks for endogeneity confirm the validity of the results.

47 This procedure is better placed to deal with the nature of our data (such as a small number of countries compared to the number of years) and to correct for panel-specific heteroscedasticity and serial correlation.

48 The finite sample bias is in the order of $1/T$, where T in our sample is 32.

Results

The results from estimating the impact of fiscal consolidation on inequality using equation (1) are presented in figure 8.3. The figure presents the estimated effect of fiscal adjustments on the Gini coefficient and the associated lower and upper confidence bands (dotted lines). Looking at the figure, it can be noted that fiscal consolidation episodes have long-lasting effects on income inequality. In particular, the estimates suggest that consolidation episodes (on average of about 1 per cent of GDP) have typically increased the Gini index by about 0.1 percentage points (equivalent to about 0.4 per cent) in the very short term⁴⁹—1 year after the occurrence of the consolidation episode—and by about 0.6 percentage points (equivalent to 2.5 per cent) in the medium term—12 years after the occurrence of the consolidation episode.⁵⁰ In addition, the Gini coefficient has typically reached the peak around 8 years following the occurrence of a consolidation episode, after which it has gradually declined.

To check the robustness of the results, equation (1) is re-estimated by including time fixed effects to control for specific time shocks, such as those affecting world interest rates. The results for this specification remain statistically significant and broadly unchanged (figure 8.4, panel B).

As shown by Teulings and Zubanov (2010), a possible bias from estimating equation (1) using country fixed effects is that the error term of the equation may have a non-zero expected value, owing to the interaction of fixed effects and country-specific arrival rates of consolidation episodes. This would lead to a bias of the estimates that is a function of k . To address this issue and check the robustness of our results, equation (1) has been re-estimated by excluding country fixed effects from the analysis. The results reported in panel C of figure 8.4, however, suggest that this bias is negligible (the difference in the point estimate is small and not statistically significant).

Estimates of the impact of consolidation on inequality could be biased because of endogeneity. In particular, while potential reverse causality is addressed by estimating changes in the Gini coefficient in the years that follow the occurrence of a consolidation episode, it could still be the case that unobserved factors influencing the dynamics of the Gini coefficient may affect the probability of the occurrence of a consolidation episode. In particular, a significant deterioration in economic activity, which would affect unemployment and inequality, may determine an increase in the debt-to-GDP ratio via automatic stabilizers, and therefore increase the probability of consolidation. To address this issue, equation (1) is augmented to control for: (a) contemporaneous and past crises episodes (banking and currency crises); (b) change in economic activity (proxied by real

49 This result is in line with Agnello and Sousa (2012), who find that fiscal consolidation leads to a short-term increase in the Gini of about 0.3 per cent.

50 This result, however, has to be treated with caution given the large uncertainty surrounding the estimates over the long term.

GDP growth); and (c) change in unemployment. The results of this exercise are reported in panel D of figure 8.4 and confirm the robustness of our results.

Finally, as an additional robustness check, equation (1) has been re-estimated for different lags (l) of changes in the Gini coefficient. The results presented in figure 8.5 confirm that the results are not sensitive to the choice of the number of lags. In particular, the peak effect ranges from 0.8 percentage points in the case of five lags to about 1 percentage point in the case of zero lags.

Spending- versus tax-based consolidation episodes

Does the composition of fiscal consolidation (spending- versus tax-based) matter for inequality? There is a broad consensus in the literature that tax-based consolidations are typically more distortionary than spending-based consolidations and therefore more contractionary over the medium term.⁵¹ In particular, Guajardo and others (2011) find that, in the case of tax-based programmes, the effect of a fiscal consolidation of 1 per cent of GDP on output is -1.3 per cent after two years, while in the case of spending-based programmes it is -0.3 per cent after two years and not statistically significant. Similarly, their results show that the effect of tax-based consolidations on unemployment is about three times larger than spending-based consolidation and much more persistent. Based on this evidence, it is reasonable to expect that the composition of fiscal consolidation also matters for inequality, and that tax-based programmes are likely to have a larger and more persistent effect.

To test for this hypothesis, equation (1) is separately estimated for tax-based and spending-based consolidation episodes, by constructing starting date dummies of taxes and spending consolidation episodes.⁵²

The results presented in figure 8.6 show that while spending and tax-based programmes have a similar effect over the short and medium term, tax-based consolidation measures typically lead to a more persistent increase in income inequality. This result corroborates the finding that austerity measures based on tax programmes are typically more contractionary than spending consolidation measures.

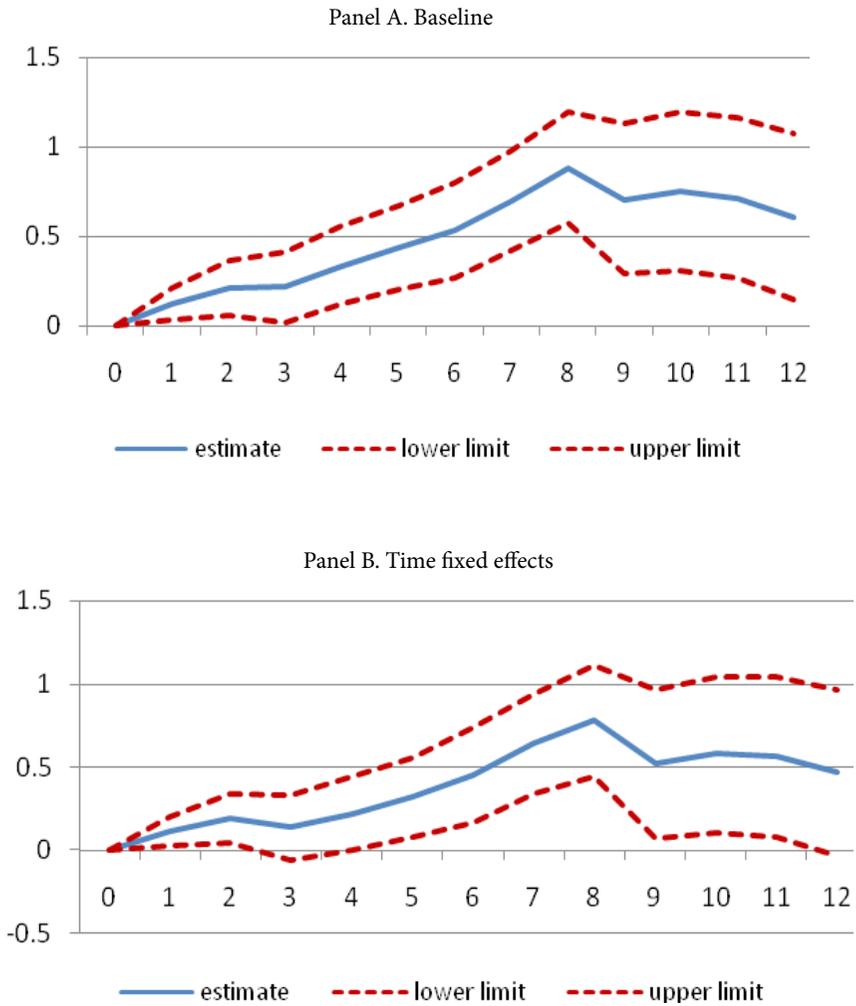
Wage versus profit income

Another way to assess the distributional effects of fiscal consolidation measures is to look at the effect of fiscal consolidations on different types of income. A traditional way of splitting total income is into wages, profits and rents. This harks back to times when the roles of workers, capitalists and landlords were fairly distinct. While these distinctions have eroded somewhat over time, the

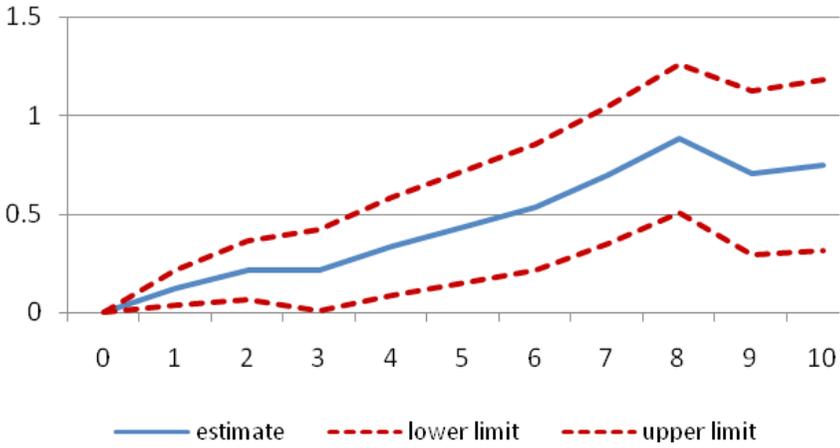
51 See, for example, Alesina and Perotti (1995, 1997), Alesina and Ardagna (2010), Broadbent and Daly (2010), and Guajardo, Leigh and Pescatori (2011).

52 The average magnitude of both spending- and tax-based consolidation is about 1 per cent of GDP.

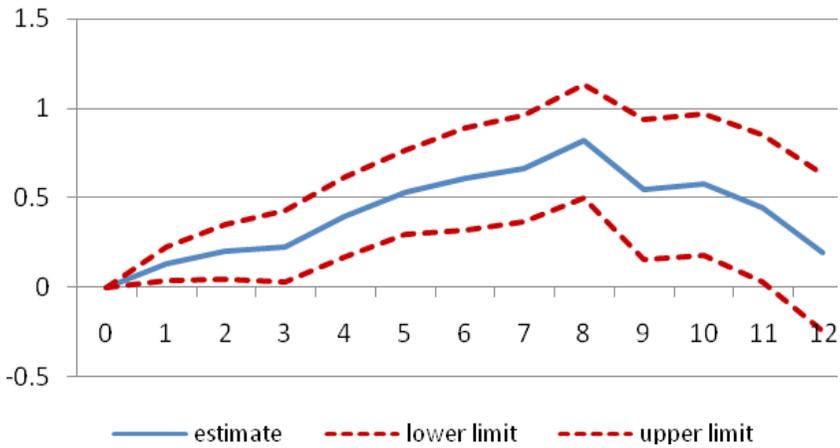
Figure 8.4. The effects of fiscal consolidation on inequality - robustness check for different sets of control



Panel C. No country fixed effects



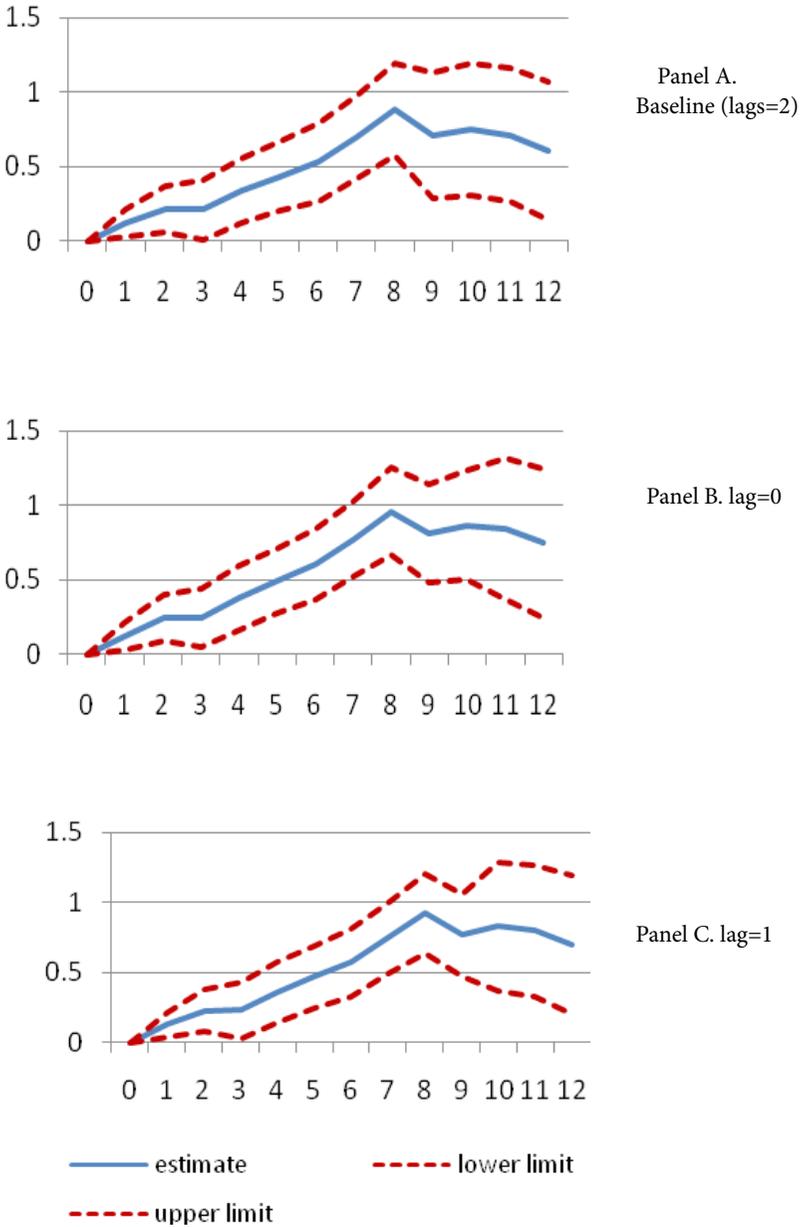
Panel D. Additional controls

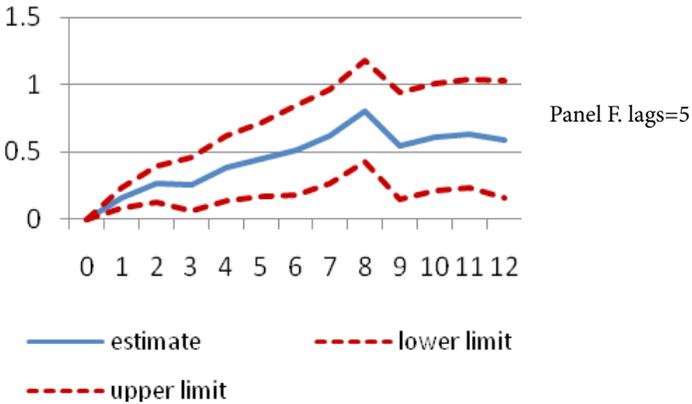
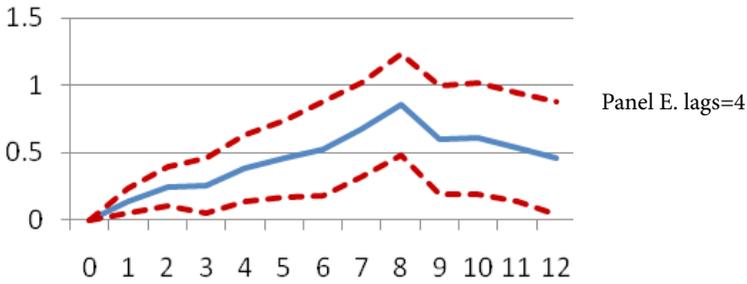
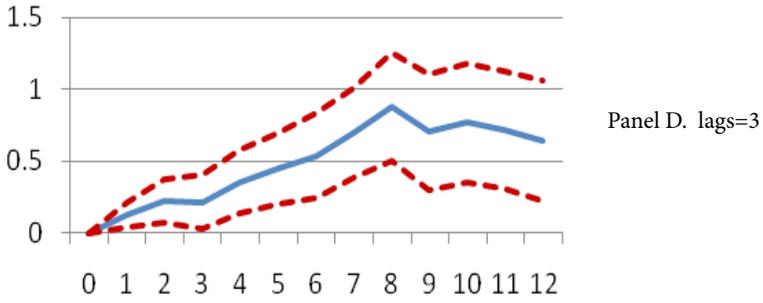


Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009). (Authors Calculations).

Note: dotted lines equal one standard error bands. Gini coefficient in the y-axis, years in the x-axis

Figure 8.5. The effects of fiscal consolidation on inequality - robustness check for different lags

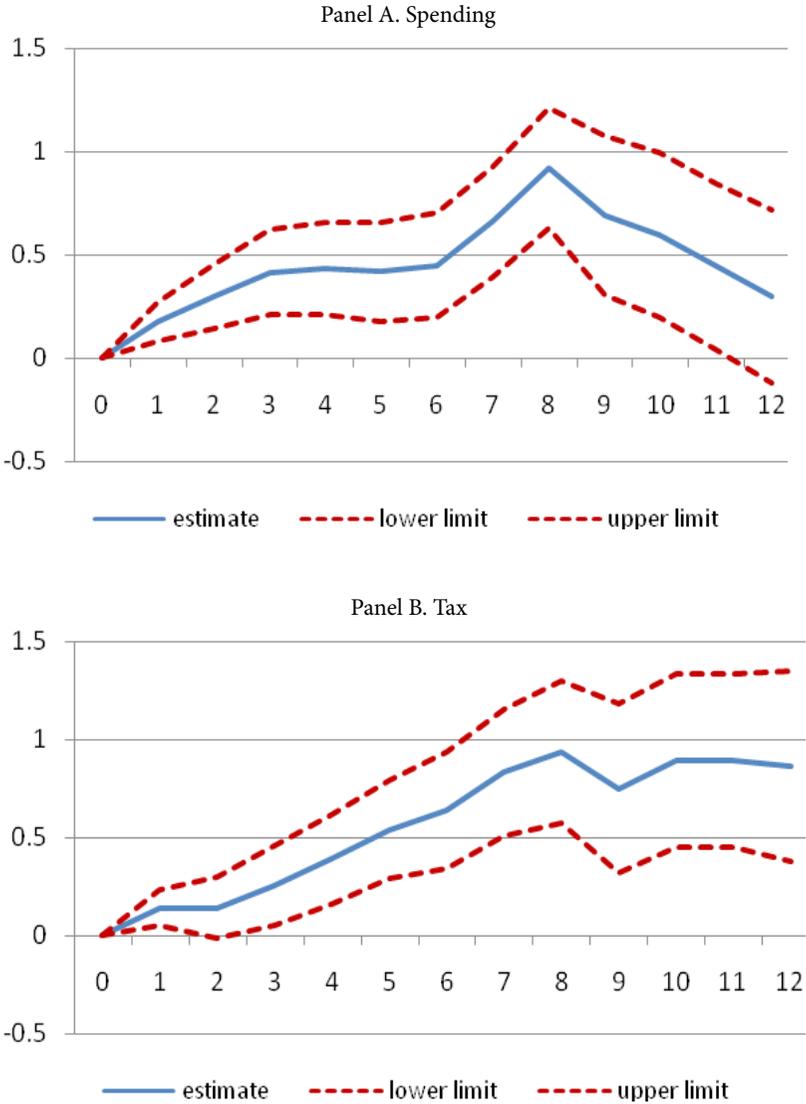




Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009). (Authors Calculations).

Note: dotted lines equal one standard error bands. Gini coefficient in the y-axis, years in the x-axis

Figure 8.6. The effects of fiscal consolidation on inequality-spending vs. based measures



Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009). (Authors Calculations).

Note: dotted lines equal one standard error bands. Gini coefficient in the y-axis, years in the x-axis

split between wages and other forms of income represents a starting point for describing how income is divided between “Main Street” and “Wall Street”.

To assess the effects of fiscal consolidation on the distribution of income between wage earners and others, equation (1) is estimated for wage income:

$$W_{i,t+k} - W_{i,t} = \alpha_i^k + Time_i^k + \sum_{j=1}^l \gamma_j^k \Delta W_{i,t-j} + \beta_k D_{i,t} + \varepsilon_{i,t}^k$$

where W represents the share of wage in GDP.

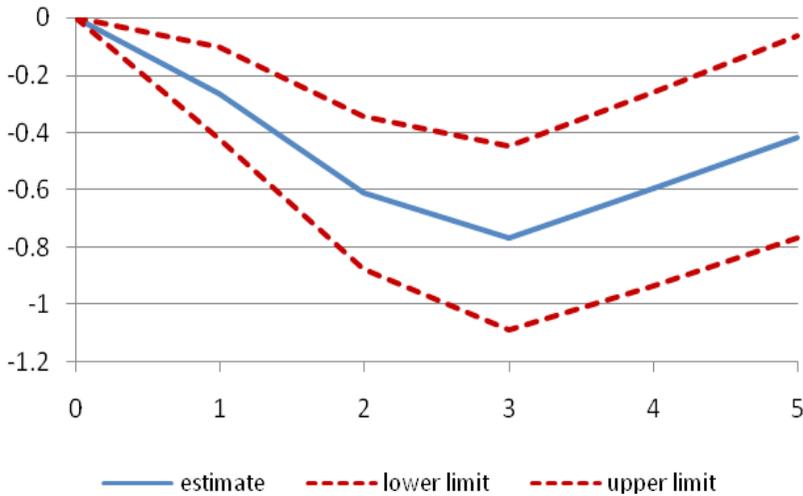
The results of this empirical exercise are reported in figure 8.7, and suggest that fiscal consolidation measures typically reduce the slice of the pie going to wage earners, while they do not have significant effects on profit and rent incomes. The reasons why wage income declines more than profits and rents have not yet been studied much in the literature. Some fiscal austerity plans call for public sector wage cuts, thus providing a direct channel for this effect. But there could be an indirect channel as well, for instance because consolidations increase unemployment, and particularly the share of long-term unemployed in the total (Morsy, 2011).

Conclusions and policy implications

This chapter examines the distributional effects of fiscal austerity. Using episodes of fiscal consolidation measures for a sample of 17 OECD countries over the period 1978-2009, it shows that fiscal consolidation episodes have typically led to a significant and long-lasting increase in inequality. Differentiating between spending- versus tax-based consolidation episodes, the results suggest that the latter tend to have a more persistent effect. The empirical evidence presented in the chapter also shows that while fiscal consolidation measures have typically led to a fall in wage income, they have not had a significant effect on profit and rent income.

- The results described here show that it is important to have realistic expectations about the consequences of fiscal consolidation: in addition to lowering incomes—hitting wage earners more than others—and raising unemployment, it is likely to lead to a long-lasting increase in inequality. These costs must be balanced against the potential longer-term benefits that consolidation can confer as interest rates decline, and the lighter burden of interest payments permits cuts to distortionary taxes.
- Fiscal measures that are approved now but only take effect to reduce deficits in the future—when the recovery is more robust—would be particularly helpful. Examples include linking statutory retirement ages to life expectancy and improving the efficiency of entitlement programmes. In contrast, fiscal consolidations that are unduly hasty pose risks to the

Figure 8.7. The effects of fiscal consolidation on wage income (% of GDP)



Source: Solt, Frederick, *Standardized World Income Inequality Database*, Version 3.1, released December 2011. Available at: <http://myweb.uiowa.edu/fsolt/swiid/swiid.html>. See also Solt (2009). (Authors Calculations).

Note: dotted lines equal one standard error bands. Wage income in the y-axis, years in the x-axis.

recovery. Therefore, countries with the scope to do so should opt for a slower pace of consolidation, combined with policies to support growth. In countries such as the United States, where unemployment remains at historical highs and long-term unemployment is at alarming levels, more active policies are needed to spur job creation and increased consumer confidence, including measures such as mortgage relief for distressed homeowners.

- Fiscal consolidation plans should also spell out how policies would respond to shocks, such as slower growth than envisaged in the plan. For instance, plans could specify that unemployment benefits would be shielded from cuts in the event of growth slower than assumed in the plan. History shows that fiscal plans succeed when they permit some flexibility while credibly preserving the medium-term consolidation objectives (International Monetary Fund, 2011; see also Mauro, 2011).

References

- Agnello, Luca, and Ricardo M. Sousa (2012). How does fiscal consolidation impact on income inequality? Banque de France, Document de Travail 382.
- Alesina, Alberto, and Roberto Perotti (1995). Fiscal expansions and fiscal adjustments in OECD countries. *Economic Policy*, vol. 10 No. 21, pp. 205-248.
- (1997). Fiscal adjustments in OECD countries: Composition and macro-economic effects. IMF Staff Papers, vol. 44, No. 2, pp. 210-248.
- Alesina, Alberto, and Silvia Ardagna, (2010). Large changes in fiscal policy: Taxes versus spending. *Tax Policy and the Economy*, vol. 24, Jeffrey R. Brown (ed). Cambridge, MA: National Bureau of Economic Research.
- Atkinson, Anthony B., and Salvatore Morelli (2011). Economic crises and inequality. Human Development Research Paper 2011/06. Human Development Report Office, United Nations Development Programme.
- Beck, Nathaniel, and Jonathan N. Katz (1995). Nuisance vs. substance: specifying and estimating time-series-cross-section models. *Political Analysis*, vol. 6, pp.1-36.
- Broadbent, Ben, and Kevin Daly (2010). Limiting the fall-out from fiscal adjustment. Global Economics Paper No. 195. Goldman Sachs Global Economics, Commodities and Strategy Research.
- Cameron, David (2011). Speech to the World Economic Forum Annual Meeting, 28 January 2011. Available from <http://www.newstatesman.com/economy/2011/01/europe-world-growth-values>.
- Cerra, Valerie, and Sweta Chaman Saxena (2008). Growth dynamics: The myth of economic recovery. *American Economic Review*, vol. 98, No. 1, pp. 439-457.
- Devries, Pete, Jaime Guajardo, Daniel Leigh and Andrea Pescatori (2011). A new action- based dataset of fiscal consolidation. IMF Working Paper No. 11/128. Washington, D.C.: International Monetary Fund.
- Furceri, Davide, and Aleksandra Zdzienicka (2012). The consequences of banking crises for public debt. *International Finance*, vol. 15, No. 3, pp. 289-307.
- Giavazzi, Francesco, and Marco Pagano (1990). Can severe fiscal contractions be expansionary? Tales of two small European countries. NBER Macroeconomics Annual, vol. 5, pp. 75-122. National Bureau of Economic Research. Cambridge, MA: The MIT Press.
- Guajardo, Jaime, Daniel Leigh and Andrea Pescatori (2011). Expansionary austerity: New international evidence. IMF Working Paper No. 11/158. Washington, D.C.: International Monetary Fund.
- International Monetary Fund (2011). What failed and what worked in past attempts at fiscal adjustment. *Fiscal Monitor: Shifting Gears: Tackling Chal-*

- lenges on the Road to Fiscal Adjustment*. Appendix 4. Washington, D.C. April.
- (2012). *Fiscal Monitor: Balancing Fiscal Policy Risks*. Washington, D.C. April.
- (2013). *Fiscal Monitor: Fiscal Adjustment in an Uncertain World*. Washington, D.C. April.
- Jenkins, Stephen, Andrea Brandolini, John Micklewright and Brian Nolan (2011). The great recession and the distribution of household income. Milan: Fondazione Rodolfo De Benedetti. Available from http://www.frdb.org/upload/file/report_1_palermo.pdf.
- Jorda, Oscar (2005). Estimation and inference of impulse responses by local projections. *American Economic Review*, vol. 95, No. 1, pp.161–82.
- Mauro, Paolo (ed.) (2011). *Chipping Away at the Public Debt: Sources of Failure and Keys to Adjustment in Public Debt*. International Monetary Fund. Hoboken: John Wiley and Sons.
- Morsy, Hanan (2011). Unemployed in Europe. *Finance and Development*, vol. 48, No. 3, pp. 24-25.
- Mulas-Granados, Carlos (2005). Fiscal adjustments and the short-term trade-off between economic growth and inequality. *Revista de Economia Publica*, vol. 172, No. 1, pp. 61-92.
- Organization for Economic Cooperation and Development (2011). OECD Economic Outlook 87. Statistics and Projections.
- Reinhart, Carmen M., and Kenneth Rogoff (2009). The aftermath of financial crises. *American Economic Review*, vol. 99, No. 2, pp. 466-472.
- Smeeding , Timothy (2000). Changing income inequality in OECD countries: updated results from the Luxembourg Income Study (LIS). Luxembourg Income Study, Working Paper No. 252.
- Solt, Frederick (2009). Standardizing the World Income Inequality Database. *Social Science Quarterly*, vol. 20, No. 9, pp. 231-242.
- (2011). Standardized World Income Inequality Database, Version 3.1, released December 2011.
- Teulings, Coen, and Nick Zubanov (2010). Economic recovery a myth? Robust estimation of impulse responses, CEPR Discussion Paper 7800. London: Centre for Economic Policy Research.

Chapter 9

Achieving full, productive and freely chosen employment for young people

STEVEN MILLER

The nature and dimensions of youth employment⁵³

Youth unemployment

Youth employment has been a persistent global challenge over recent decades. While there has been some progress in reducing youth unemployment during the past decade, the ongoing financial and economic crises have reversed such progress. The youth unemployment rate rose from 11.6 per cent in 2007 to 12.7 per cent in 2010 (International Labour Office, 2012a).

Overall, the number of unemployed youth (aged 15-24) is estimated to have declined only slightly from a high of 75.4 million in 2009 to a projected 74.6 million in 2012, which remains well above the 2007 level of 70.3 million. Youth unemployment has been most sensitive to the global crisis in industrialized countries, and has reached record levels of 54 per cent in Spain and 58 per cent in Greece.⁵⁴ But, even before the crisis, employment growth had not been sufficient to absorb the growing cohort of young workers.

When trends on youth participation are factored in, the situation of young people within global labour markets is even more unsettling. Globally, youth labour force participation rates decreased by 4.1 percentage points between 2000 and 2010. Previous to the global economic crisis, the decline in youth labour

53 This overview of recent global and regional trends in youth employment draws primarily on the following recent International Labour Organization (ILO) publications: “Global Employment Trends for Youth 2012”; and “The youth employment crisis: Time for action”, report to the 101st Session of the International Labour Conference.

54 Data from the European Commission, Eurostat can be found at http://epp.eurostat.ec.europa.eu/portal/page/portal/euroindicators/labour_market/main_tables.

market participation had largely been a result of young people prolonging their education and delaying entry to the labour market. The change at the global level is driven to an important extent by the large decreases during the past ten years in South Asia (-6.7 per cent), East Asia (-5.3 per cent) and in South-East Asia and the Pacific (-3.8 per cent), all regions where huge strides have been made in educational enrolment. The crisis, however, impacted youth participation in a different way, discouraging many from entering the labour market owing to their lack of hope in finding a job. According to the International Labour Office's *Global Economic Trends for Youth 2012* report "The crisis-induced withdrawal from the labour force amounts to 6.4 million young people worldwide" (International Labour Office, 2012a, p. 7), which means that the adjusted global youth unemployment rate would be 13.6 per cent (compared with the actual rate of 12.6 per cent).

Those regions with the highest participation rates (namely, East Asia, South-East Asia and the Pacific, developed economies and the European Union and South Asia) also saw the largest decreases in participation over the decade. Some of the youth in these regions, which are characterized by above average levels of economic growth, have reacted to the crisis by extending their education and waiting for better times before entering the labour market. However, an increasingly large share of young people are neither in employment, education nor training (NEET). The NEET rate for the Organization for Economic Cooperation and Development (OECD) countries was 12.8 per cent for 2010 (International Labour Office, 2012a), signifying a crisis-induced growth in social exclusion and dislocation from the labour market.

Youth population in countries at different levels of development

Although the youth share of the working age population is on the decline in most regions of the world, the absolute number of young people remains much higher and continues to grow in the least developed regions of the world (table 9.1). Those regions with a large "youth bulge" within the overall demographics of the working age population are: sub-Saharan Africa (35.4 per cent), the Middle East (30.8 per cent), North Africa (29.9 per cent), South Asia (28.9 per cent), South-East Asia and the Pacific (25.6 per cent) and Latin America and the Caribbean (25.1 per cent). Whether this youth bulge is a problem, as conventional wisdom would have it, or a demographic bonus, is a matter of debate.

While a large youth cohort combined with high rates of unemployment is an explosive mix, a whole set of different problems arise in those countries where a relatively small youth cohort coincides with growing dependency ratios, meaning that young people are faced not only with the burden of finding and keeping a job, but also with that of taking care of an ageing population.

Youth in working poverty, informal and vulnerable employment

Unemployment rates do not reflect the fact that many young people are trapped in low-quality jobs and underemployment in the informal economy, as well as in vulnerable forms of employment in the formal economy. Over 90 per cent of young people live in developing countries and fewer young people show up in the unemployment statistics of developing countries than in those of industrialized countries owing to high degrees of employment in the informal economy. Although these young people are, strictly speaking, employed, the quality of this employment is low as measured in terms of remuneration, working hours and productivity. Since most developing countries lack State-sponsored social safety nets, many young people have no choice but to earn a survival income in the informal economy.

Evidence points to the fact that young people are disproportionately represented amongst the ranks of the working poor. “In the 52 countries for which data is available, youth accounted for 23.5 per cent of the total working poor, but only 18.6 per cent of non-poor workers” (International Labour Office, 2012b, p. 13). The explosive combination of a well-educated young population and a deficit of decent jobs helps to describe the growing frustration of young people in many regions of the world, such as North Africa and the Middle East.

The conventional wisdom on youth employment

Job creation is habitually perceived to be a result of sound macroeconomic policies, of efforts to promote private sector development, including through a competitive business environment and reducing the cost of doing business, and finally of correcting mismatches between job seekers and employers in the labour market. Traditionally, this has meant fiscal and monetary policies which focus on reducing public debts, targeting inflation, encouraging foreign direct investment (FDI) and promoting exports as means to stimulate economic growth which in turn—it was argued—would create jobs. Beyond this overall framework for job creation, youth employment policies have been largely targeted and based on special labour market programmes in the fields of training and self-employment.

Training and employability

Lack of appropriate skills and work experience are seen to be key entrance barriers to the labour market. In a Youth Employment Inventory carried out by the World Bank in the framework of its partnership with the Youth Employment Network, 38 per cent (111 out of 289) of youth employment interventions recorded in 2007 addressed skills barriers through training (Betcherman and others, 2007). Training has become the standard conventional wisdom with respect to barriers

youth face in making the school-to-work transition. However, vocational training programmes have typically been evaluated in terms of the number of youth trained and successfully placed in employment, whereas longer-term retention and issues of job displacement have not been addressed systematically.

One avenue to improve youth employability includes making general and technical secondary education more skills- and career-oriented. Often the knowledge and skills acquired in the formal education system are poorly adapted to the needs of employers, and to the self-employed; and therefore supplementary training is required to make young people “employable” by industry standards. This can be done by bringing the workplace into schools and also by bringing schools into the workplace. The German Dual System is one well-known initiative which divides the technical secondary school week between time spent in the classroom and time spent under the direct supervision of employers in places of work. This system has been promoted in various forms by German technical cooperation projects around the world, such as the Mubarak-Kohl Dual System (MK-DS) which ran for 14 years in Egypt. While this programme appeared to be successful in helping those young people who were enrolled in special DS schools to find and retain a formal sector job, it covered only a small percentage of the workforce enrolled in secondary technical education; and it did not seem to help youth working in the informal economy to break into formal sector employment (Adams, 2010).

Putting the DS training approach in the historical and macroeconomic context in which it was implemented in Egypt can help in better understanding its objectives and limitations. President Hosni Mubarak and German Chancellor Helmut Kohl agreed in 1991 on a programme of German technical cooperation that would help Egypt address weaknesses in its secondary technical education system and support economic reforms (Adams, 2010). The economic reforms revolved around providing a skilled and disciplined workforce for new export-oriented enterprises. Despite the fact that many of the opportunities were in relatively labour-intensive sectors such as the ready-made garment industry, the period from the early 1970s through the 1990s was marked by a fivefold rise in unemployment rates, a doubling of capital output ratios and a marked growth of informal forms of employment. Overall, while the Egyptian Dual System may have served the labour requirements of investors seeking to reach new export markets and be successful in highly competitive sectors, the DS training programme did not respond to the aspirations of the majority of Egypt’s young people.

Similarly, in Tunisia, where youth unemployment likewise spurred a popular revolution, high levels of education and labour market preparedness did not address the need for job creation. Fadhel Kaboub (2007, p. 8) wrote prophetically:

High unemployment is not only an economic problem, but it is also increasingly becoming a social and political issue that has the potential to destabilize Tunisia if not dealt with promptly

and strategically.... Tunisia has spent 25 % of its annual government budget on public education... In 2006, for the first time in Tunisia's history, *two thirds of the first-time job seekers have a university degree.*

Recognizing the limitations of training programmes which are focused quasi-exclusively on employers' and labour market needs without integrating a clear understanding of youth motivations in the labour market, there has been a movement towards more comprehensive "training plus" approaches. These programmes, which have been positively evaluated in a number of Latin American countries, combine vocational, in-classroom training with workplace-based training plus a variety of intermediation services (Fares and Puerto Gonzalez, 2009).

A World Bank evaluation of skills training, work experience, apprenticeship and school-to-work transition programmes (Adams, 2007) lays out the potential benefits of such programmes, but also their limitations unless the demand side of the equation is simultaneously addressed: "Employers are unlikely to take

Table 9.1 Youth share of working age population, 1997, 1998 and 2006-2009 (percentage)

	1997	1998	2006	2007	2008	2009
World	25.8	25.7	24.9	24.7	24.7	24.4
Developed economies and European Union	16.8	16.7	15.7	15.5	15.4	15.2
Central and SouthEastern Europe (non-European Union) and Commonwealth of Independent States	22.0	22.1	22.2	21.9	21.5	21.0
South Asia	30.6	31.0	29.6	29.5	29.2	28.9
South-East Asia and the Pacific	29.8	29.4	26.9	26.5	26.0	25.6
East Asia	22.6	21.8	21.0	20.8	21.6	21.3
Latin America and the Caribbean	29.3	29.0	26.2	25.8	25.5	25.1
Middle East	34.4	34.9	33.3	32.7	31.6	30.8
North Africa	33.1	33.3	31.0	30.5	30.6	29.9
Sub-Saharan Africa	35.7	35.7	36.1	36.1	35.5	35.4

Sources: International Labour Office (2008), Global Employment Trends for Youth, annex A8, p. 54; and International Labour Office (2010), Global Employment Trends for Youth, Special Issue on the Impact of the Global Crisis on Youth, annex A1, p. 61.

on board large numbers of youth for training when conditions for sustained employment are not present.” (Ibid., p. 2.)

Wray (2007) and Minsky (1973) argue that public policy that favours education and training over job creation puts “the cart before the horse” and is unlikely to succeed. Such policies lay the blame on the unemployed for their own situation. They can send the message that young people must change their behaviour or their personal characteristics in order to get a job. Furthermore, there is always a danger that training policies will only increase competition amongst the unemployed over scarce available jobs, and rather than increase employment, will simply displace previously employed workers (Wray, 2007).

Nevertheless, youth employment initiatives continue to embrace a nearly exclusive focus on training and skills development while the levels of investment in education and training have never been higher. Training will not resolve the fundamental problem of structural unemployment, underemployment and informality. The wave of popular uprisings in North Africa in 2011 has brought home this message forcefully.

Self-employment

Programmes to promote self-employment and entrepreneurship amongst young people provide the second main thrust for youth employment policy. However, only a minority of young people have the desire, motivation and capabilities to succeed in business and the majority of young entrepreneurs are driven by necessity. Entrepreneurship or self-employment are rather taken up as a result of the lack of wage employment opportunities. A 2006 survey of young entrepreneurs in 14 Latin American countries (Llisterri and others, 2006, pp. 2 and 4) found that:

Young entrepreneurs can be divided into two broad groups: those who become entrepreneurs by necessity because they are unable to find other forms of formal employment or continue their education, and what can be called “vocational entrepreneurs” who seize a business opportunity.

...

Most young entrepreneurs are self-employed. Household data for a sample of 14 Latin American countries covering 89 percent of the total population show that 12.8 per cent of workers between the ages of 16 and 24 are entrepreneurs. Most of them (11.9 per cent) can be classified as self-employed by necessity, while the rest (0.9 per cent) are employers. . . . Young entrepreneurs are a small segment of the total universe of entrepreneurs.

Despite the sparse and ambiguous results of studies of youth entrepreneurship, these programmes remain extremely popular with funding organizations from the private and public sectors. This appears to be in part because of the lack of

other viable employment creation alternatives, and in part because of an almost ideological preference for private sector options for job creation, to the quasi-exclusion of other, including public sector, alternatives.

Complementary policies for youth employment

Integrating youth into mainstream job creation policies

Better preparing young people for an insufficient number of decent jobs will not solve the problem of youth unemployment and underemployment. Furthermore, better matching between job seekers and potential employers may ease structural unemployment, but it will not address the fundamental problem of lack of decent work. Whereas training and intermediation services will continue to play a role in any comprehensive youth employment strategy, durable progress cannot be made without policies and programmes which create additional and good quality employment opportunities for new labour market entrants, that is, young people. Wray (2007) argues that policies which focus on training and motivating the unemployed or try to address skills' mismatches conceal the true problem—a chronic job shortage (*ibid.*).

To address job shortages, the focus is typically on supporting the private sector to create new and additional employment. There are a number of strategies to encourage private sector job creation. Wray (*ibid.*) discusses hiring and wage incentives which government can provide to employers. These, however, carry many potential drawbacks, such as the danger that the private sector will simply reduce the cost of existing employment, rather than create new jobs for those unlikely to find employment otherwise.

Another means commonly advocated to encourage the private sector to hire workers is to introduce greater flexibility into labour market regulations on hiring and firing workers and into their conditions of employment. The World Bank—International Finance Corporation Doing Business Initiative rates countries based on the ease of setting up and operating a business, with the implicit assumption that the easier it is to create and maintain a business, the better it will be for job creation (International Finance Corporation and the World Bank, 2010). A dialogue between the World Bank and the International Labour Organization (ILO) on the Employing Workers Indicator has led to a modification of this indicator to give greater emphasis to the importance of social protection for a competitive business environment and to stop using it as a component of the overall Doing Business rankings.⁵⁵ There is little concrete evidence which ties the ease of doing business

55 Doing Business measures the regulation of employment, specifically as it affects the hiring and redundancy of workers and the rigidity of working hours. In 2007 improvements were made to align the [methodology](#) for the Employing Workers indicators with the relevant International Labour Organization (ILO) conventions, and in 2010, the Employing Workers indicators were removed both from the overall Doing Business rankings and were no longer used as a basis for policy advice. See Berg and Cazes, 2006.

to decreased levels of youth unemployment or underemployment.

Whereas the private sector will continue to be the main engine for job creation, there is a new openness to the role of the State in employment policy, particularly in light of the massive public sector interventions in both industry and in the banking sector as a result of the global financial crisis (2007-2009). However, with the political environment increasingly focused on austerity rather than on stimulus, this window of opportunity is rapidly closing; and it is essential to quickly put in place the basic pillars of an employment-generating macro-policy framework as well as direct job creation programmes.

Whereas the tendency over the past decades has been for the government to withdraw from key areas of intervention, wage policy, industrial policy and investment policy are all worth revisiting in order to leverage their potential impacts on youth employment. Macroeconomic, sectoral and labour market policies are often neglected with respect to youth employment, which is usually confined to the realm of active labour market programmes. Policies for the promotion of youth employment suffer from being labelled as “special” or “targeted” interventions, and hence end up becoming temporary measures which inadequately address the essence of a structural and long-term phenomenon.

Youth in the informal economy

Since the majority of young people in the world are involved in informal employment relationships, a clear understanding of the heterogeneity and the dynamics of informal work are important in helping create new employment opportunities while at the same time addressing decent work deficits. The World Bank highlights two sides to informality. On the one hand, citizens may be *excluded from* formal institutions and employment opportunities. On the other, “workers, firms and families, dissatisfied with the performance of the state or simply not finding any benefit to interacting with it, *opt into* informality” (Perry and others, 2007, p. xi). The International Labour Office (2007) argues that informality arises less as a result of individual choice and more as the result of lack of alternative employment opportunities. Lack of State capacity or political will to create decent employment in the formal economy are the problem.

The International Labour Office (2007) maintains that not all informality can be ascribed to excessive regulations driving economic agents into the shadows of informality. There are activities or groups that fall outside the national regulatory framework, such as the self-employed, domestic workers or new forms of employment such as subcontracting. Where laws exist, lack of compliance and enforcement in the informal economy is the problem. Yet, in some instances, the regulatory framework is not seen as a provider of basic protection or an instrument

Also, see the World Bank’s Doing Business website regarding the changes which have been made with respect to the Employing Workers index, available from <http://www.doingbusiness.org/data/exploretopics/employing-workers>.

for creating a level playing field but as an impediment to employment creation and a factor contributing to the spread of informality.

Since informality is often characterized by long hours, low productivity and revenues and poor working conditions, the challenge is to improve working conditions, productivity and earnings. Policy interventions have tended to focus on training and capacity-building efforts for workers and enterprises in the informal economy, a supply-side approach. However, a focus on the demand for the goods and services produced by the informal economy is also called for, one which not only takes into account the heterogeneity of informal work and production but also addresses its varying degrees of integration within the formal economy. Rather than viewing the informal economy as a marginal phenomenon, destined to disappear as countries develop, informality should be seen as an integral feature of modern capitalist development, one which is strategically captured not only by the survival strategies of informal workers, local micro- and small enterprises and their dependents, but also by industries and economic sectors seeking to take advantage of global supply chains.

In conclusion, the key policy avenue for addressing decent work deficits for young people in the informal economy would be to promote the creation of decent work in the formal economy. The following section explores the role which public employment programmes can play in this regard.

Youth in public employment programmes

There is renewed interest in public employment programmes as a vehicle for *directly* providing employment opportunities, coupled with training and work experience, to young people. The manner in which public employment programmes have linked job creation with delivery of basic infrastructure and services has been evolving over recent decades. In the follow-up to the World Employment Conference of 1976, the ILO launched a global initiative in favour of labour-intensive Special Public Works Programmes (SPWPs). The objective was to mobilize international assistance in favour of short-term job creation (for example, in response to the drought that hit the Sahel in the 1970s), while putting in place much needed infrastructure as a basis for sustainable employment creation.

The SPWPs were initially rural projects such as water supply, reforestation, erosion control, small dam construction, irrigation, watershed management, feeder road construction and improvement, and construction of buildings such as schools, health centres and cereal banks. Later, urban works such as slum upgrading, street paving, sanitation and drainage were included. Rather than being limited to a series of stand-alone labour-intensive projects, the ILO approach, now implemented under the Employment-Intensive Investment Programme created in the 1980s, has evolved towards increasing the employment content of infrastructure investments, without compromising technical standards and long-

term sustainability (International Labour Office, 1998). This programme, which now has more than 30 years of experience in over 70 countries, has been largely supply-driven in that it seeks to increase the employment impact of already-allocated project funding and infrastructure investment budgets.

Major public investment programmes are under way in a number of countries, such as South Africa's Expanded Public Works Programme and Ethiopia's Productive Safety Nets Programme. However, there is new interest in moving from a supply-driven to a demand-driven approach in the form of employment guarantee programmes, such as India's National Rural Employment Guarantee Act (NREGA)⁵⁶ (Lal and others, 2010). Rather than using the limited supply of public investment resources as their starting point for job creation, employment guarantee programmes (see below) are demand-based in that they respond to the overall demand for employment opportunities.

Many of the World Bank's Youth Employment Loans and Grants to developing countries contain public works as a major, if not the primary, component. Such programmes include components such as procurement and community contracting, which can have multiplier effects. They inject workers' income into the local economy, which can help young people contribute to demand-led economic growth and sustainable employment⁵⁷ (World Bank, 2010). Cunningham (2009) presents public service programmes with a list of possible active labour market responses to constraints and labour market failures facing young people. Infrastructure development and public service can provide meaningful work experiences which can accommodate the specific needs and interests of young people.

An employment guarantee for young people?

The ongoing structural nature of youth unemployment calls for a permanent mechanism for youth job creation. Given the high costs to society of unemployment and underemployment of young people—in terms of forgone production, increased welfare and transfer payments, decreased fiscal revenues, social unrest and deterioration of human capital—policies wherein Governments, either at the local or national level, agree to step in and become “employer of last resort” may prove to be a cost-effective strategy for youth employment⁵⁸ (Lal and others, 2010; Wray, 2007). Rather than making training a prerequisite for young people finding employment, an employer of last resort, or employment guarantee

56 For further background, see Lal and others (2010) and ILO (1998).

57 See World Bank, 2010. Also, for an overview of different strategies and approaches for both supply- and demand-driven public employment programmes, see Lal and others (2010).

58 For further background on the concept and examples of Employer of Last Resort, or employment guarantee programmes, see Lal and others (2010); Wray (2007); and the website of the Economists for Full Employment network, available from www.economistsforfullemployment.org.

programme, can make jobs available that “take workers as they are”, regardless of their skills, education, or personal characteristics (Wray, 2007). These jobs can be created in a number of fields, including community infrastructure and services, environmental restoration and in the care economy.

Whereas such programmes may be perceived to be unaffordable, political will and conducive fiscal and monetary policies, together with the necessary government capacity, are the key requirements. Studies have shown that a universal employment guarantee could be put in place in many countries for 1-2 per cent of gross domestic product (GDP)⁵⁹ (ibid.; Harvey, 2003) and that the costs of creating employment are not prohibitive, especially when compared with the costs of unemployment. Kaboub (2007) estimated that an employment guarantee programme in Tunisia could be implemented for between 3 and 5 per cent of GDP. Although limited to rural areas, India’s NREGA is a rights-based, demand-driven programme which by law provides 100 days of work per year to everyone who applies for a job card and for work.

An employment guarantee would provide protection against economic risks and poverty traps as well as a means of defusing social tensions, and would buy time for employment-friendly economic reforms to take root. By drawing in young people who have often never before been part of the workforce, well-designed employment guarantee programmes can potentially increase their “employability” and/or facilitate re-entry into the private sector, suggesting that in many instances the private sector prefers to hire people who already have work experience or are working⁶⁰ (Wray, 2007). Employment Guarantee programmes can also complement some of the programmes aimed at *retraining* and *retaining* workers in other sectors by helping to stabilize local demand and income.

Conclusions on policy coherence for youth employment

While education and training are key factors for labour market access for young people, it must be recognized that, globally, young people are already the best educated generation ever and that education and training do not create jobs. Furthermore, underemployment in the informal economy, rather than unemployment, is the primary indicator of labour market malaise for most of the world.

While the private sector is the main driver and source of job creation, private sector industries are not creating sufficient decent jobs to meet the requirements

59 Wray (2007, p. 27) argues that the net increase of government spending would be less than 1 per cent of GDP. According to Harvey (2003), based on a comparative study of United States social and fiscal policy, the additional tax revenue requirements to fund a universal employment guarantee in the United States in 1999 would have required a 1.6 per cent increase in personal and corporate income taxes.

60 Wray (2007, p. 5) states that “Upgrading of these characteristics would be the second step—with much of the necessary training occurring on the job. The unemployed need jobs, not merely the promise of a job for those who successfully reform themselves.”

of young people entering the labour force. Likewise, these same structural constraints cannot be solved by “matching” or “signalling” a greater number of job seekers with a lesser number of decent jobs. In fact, the matching process will channel the most qualified job seekers to the limited number of decent jobs, thereby exacerbating marginalization and informality amongst the rest.

Although these constraints are generally acknowledged, the remaining solution traditionally proposed for the youth employment problem tends to be self-employment and entrepreneurship development. It is as if policymakers are telling youth that since there are not enough decent jobs available, they have two options: either accept employment which does not meet with their expectations, or create their own!

Another “solution” to the problem of youth unemployment tends to be the creation of special funds, which largely begs the question of how to use these resources most effectively to address youth unemployment and amounts to throwing money at the problem. All too often, the focus of such funds is on the distribution of microcredit to young people, at times with political motivation, to start their self-employment income-generating activities.⁶¹ The high political priority and visibility of youth employment becomes its own worst enemy. Since policies and programmes for youth employment are often targeted and special measures, they are either marginalized or treated separately from the broader macroeconomic (both fiscal and monetary) and labour-market policy debates on job creation. Whereas youth employment is often a top political priority, the solutions proposed end up being second-best.⁶²

Since young people have a proportionately greater chance of being outside the labour market, the focus of youth employment policy should be on the creation of new and additional jobs. Even if not explicitly reserved or targeted towards young people, these jobs will benefit them relatively more than they do older workers. Demand stimulation or job creation policies can be either private or public sector driven. The panoply of policy measures available to stimulate or subsidize private sector employment provides only partial answers, and usually leads to displacing existing labour.

61 For example, the Government of South Africa launched a 9 billion rand (1.1 billion United States dollars) jobs fund in 2011 which invites competitive bids from projects with innovative ideas on how jobs can be created (see <http://www.jobsfund.org.za/default.aspx>). Senegal has put in place a Youth Development Fund, based largely on microfinance grants and loans, which has had mixed results over the past decade. For a critical review of the Fund, see <http://www.lasenegalaie.com/index.php?lasenegalaie=infos&infos=politique&politique=214089>.

62 During discussions by the author with Wendy Cunningham of the World Bank on 7 September 2010, she indicated that youth employment interventions were often necessarily “second best” with respect to the potential impacts which macroeconomic policies can have on job creation. Nevertheless, such interventions could have more immediate impacts in situations where the political imperative does not allow for long-term policy impacts.

Hence, the time is now ripe to revisit direct job creation by public authorities. Such programmes should not be seen as competing with or replacing the private sector's primary role in job creation. Rather, such direct public sector driven job creation programmes provide a means of maintaining human capital during financial, civil or political crises or economic downturns while at the same time providing basic infrastructure and services which will help the private sector improve its productivity. Public job creation programmes can also provide green jobs through work which protects the natural resource base, restores the environment, addresses climate change and builds a foundation for sustainable job creation.

Direct public job creation schemes should not, of course, be seen as the only solution for addressing decent work deficits for young people. Rather, it should be an integral part of a larger menu of options available to public policymakers. Better mapping, evaluation and costing of different interventions is called for within a coherent framework.⁶³ Just as in the financial sector, where they have recently stepped in and assumed the role of lender of last resort, Governments should likewise be willing to face up to the challenge of becoming an “employer of last resort”.

63 In order to ascertain the relative requirements for different types of interventions along the supply–demand continuum outlined above, a mapping of the resources and needs with respect to youth employment should be carried out. Such mapping can be done at the national, regional and local levels. The National Youth Employment Action plan process, put into place with both political commitments and with technical resources, provides a good place to begin. Despite this demand-driven national framework, backed up by General Assembly resolutions, national commitments at the highest level and the technical resources of the United Nations system, separate and ad hoc approaches continue to prevail. See United Nations General Assembly resolution 57/165 calling for the development of National Action Plans on Youth Employment, available from <http://www.un.org/Docs/journal/asp/ws.asp?m=A/RES/57/165>.

References

- Adams, Arvil V. (2007). The role of youth skills development in the transition to work: A global review. Human Development Network Children and Youth Department Working Paper No. 5. Washington, D.C.: World Bank.
- _____ (2010). The Mubarak-Kohl Initiative–Dual System in Egypt: An assessment of its impact on the school to work transition. German Technical Cooperation (GTZ). 17 September 2010.
- Berg, Janine, and Cazes, Sandrine (2006). The Doing Business Indicators: Measurement issues and political implications. Economic and Labour Market Paper. Geneva: International Labour Office.
- Betcherman, Gordon, Martin Godfrey, Susana Puerto, Friederike Rother and Antoneta Stavreska, (2007). Global inventory of interventions to support young workers: Synthesis report. Social Protection Discussion Paper No. 0715. Washington, D.C.: World Bank.
- Cunningham, Wendy (2009). Active labor market programs for youth in Africa: A framework for engagement. Washington, D.C.: World Bank.
- Fares, J., and S. Puerto Gonzalez (2009). **Towards comprehensive training.** Social Protection Discussion Paper No. 0924. Washington, D.C.: World Bank.
- Harvey, Philip (2003). The right to work and basic income guarantees: A comparative assessment. US Basic Income Guarantee Discussion Paper No. 57.
- International Finance Corporation and the World Bank (2010). *Doing Business 2011: Making a Difference for Entrepreneurs.* Washington, D.C.: IFC and World Bank.
- International Labour Office (1998). Job creation programmes in the ILO: Employment generation for poverty reduction: The Role of employment-intensive approaches in infrastructure investment programmes. ILO Governing Body document GB.273/ESP/4/1. Geneva, Switzerland: International Labour Office. November.
- _____ (2007). The informal economy. The Governing Body, Committee on Employment and Social Policy, Document GB.298/ESP/4. Geneva, Switzerland: International Labour Office.
- _____ (2008). *Global Employment Trends for Youth.* Geneva, Switzerland: International Labour Office.
- _____ (2010). *Global Employment Trends for Youth.* Geneva, Switzerland: International Labour Office. August.
- _____ (2012a). *Global Employment Trends for Youth 2012.* Geneva, Switzerland: International Labour Office.
- _____ (2012b). The youth employment crisis: Time for action. Report to

- the 101st Session of the International Labour Conference, document ILC.101/V. Geneva, Switzerland: International Labour Office.
- Kaboub, Fadhel (2007). ELR-led economic development: A plan for Tunisia. Levy Economics Institute Working Paper 499. Annandale-on-Hudson, New York, USA: Levy Economics Institute.
- Lal, Radhika, Steve Miller, Maikel Lieuw-Kie Song and Daniel Kostzer (2010). Public works and employment programmes: Towards a long-term approach. Working Paper No. 66. Brasilia and New York: International Poverty Centre and United Nations Development Programme.
- Llisterri, Juan José, Hugo Kantis, Pablo Angelelli and Luis Tejerina (2006). Youth entrepreneurship a necessity or an opportunity? A first exploration of household and new enterprise surveys in Latin America. Sustainable Development Department, Technical Papers Series, Inter-American Development Bank. Washington, D.C.: Inter-American Development Bank.
- Minsky, Hyman P. (1973). The strategy of economic policy and income distribution. *The Annals of the American Academy of Political and Social Science*, No. 409. September, pp. 92–101.
- Perry, Guillermo E., William F. Maloney, Omar S. Arias, Pablo Fajnzylber, Andrew D. Mason and Jaime Saavedra-Chanduvi (2007). *Informality: Exit and Exclusion*. Latin American and Caribbean Studies, the World Bank. Washington, D.C.: World Bank.
- World Bank (2010). Making public works work. Final report of the South-South Learning Forum, 14–18 June, Arusha, United Republic of Tanzania. Washington, D.C.: World Bank.
- Wray, L. Randall (2007). The Employer of Last Resort Programme: Could it work for developing countries? International Labour Office, Economic and Labour Market Papers. Geneva, Switzerland: International Labour Office.

Chapter 10

Financing social and labour market policies in times of crisis and beyond

KATJA HUJO⁶⁴

Introduction

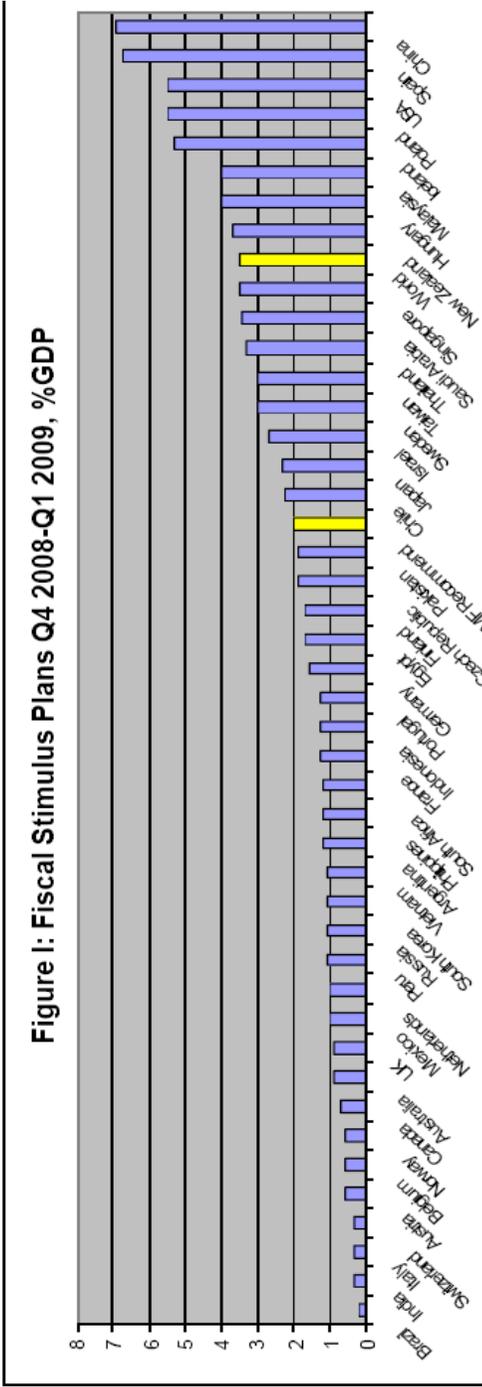
The global financial crisis that broke out in 2008 was one of the worst crises in recent decades, with countries still struggling to overcome its consequences. The Global Jobs Pact adopted by the International Labour Organization (ILO) in 2009 aimed to address the neglected social and employment impact of the crisis, promoting a recovery based on investment, employment and social protection (International Labour Organization, 2009a). The document mentioned explicitly the need to support developing countries and least developed countries (LDCs) with limited fiscal space and State capacity through additional donor funding and cooperation. In 2012, this agenda has lost nothing of its urgency: according to the United Nations Department of Economic and Social Affairs (UN/DESA), “recovery of global employment remains the most pressing challenge” (United Nations, 2012, p. 1).

This chapter will examine the question of financing labour market and social policies in a context of crisis and beyond. Although issues of financing are usually treated separately from social policy, the latter being primarily concerned with social expenditure and social outcomes, it is posited here that both have to be approached simultaneously in order to design social and economic systems that are mutually reinforcing and sustainable (Hujó and McClanahan, 2009).

The main conclusion of the chapter is that countries with broad and institutionalized social and labour market policies are better prepared to respond to a crisis situation and to reduce poverty. However, aid, international funds and stabilization mechanisms at regional and global levels are required for countries

64 United Nations Research Institute for Social Development (UNRISD) research assistance and very useful comments from Mariana Rulli and the editorial team at UN/DESA are gratefully acknowledged.

Figure 10.1 Fiscal stimulus plans, Q4 2008-Q1 2009 (percentage of GDP)



Source: Ortiz, 2009.

with limited fiscal space and high exposure to global market risks—a challenge in a global environment where rich as well as poor countries face similar financing pressures and policymakers seem to be increasingly reluctant to support a global solidarity agenda.

The chapter is organized into six parts: the second section introduces the general background, the third section discusses the concept of fiscal space and affordability, the fourth section takes a longer term view by linking revenue instruments with social development strategies, the fifth section gives some country examples on financing labour market policies, and the sixth presents conclusions.

The context: social protection and labour markets in times of crisis

The effects of the global financial and economic crisis starting in 2008 have been transmitted to the developing countries through several channels, notably foreign capital and domestic credit, trade and foreign direct investment (FDI), commodity prices and terms of trade as well as remittances. As a consequence, countries across the globe have suffered declines in national income, investment, employment, worsening fiscal accounts and balance of payments, increasing debt and financial sector distress (International Labour Organization, 2009b; International Monetary Fund, 2009; World Bank, 2009; United Nations Conference on Trade and Development, 2010).

At a micro level, the negative impact on well-being has occurred mainly through deterioration of the labour market situation (unemployment, wage declines and informalization), price hikes in financial and goods markets, effects on household income and assets (savings, assets, unpaid work, remittances) and through adverse effects on social protection provided through States, markets and communities (McCord, 2010; Mesa-Lago, 2009; Hujo and Gaia, 2011; Utting, Razavi and Buchholz, 2011).

In most countries, at least initially, the public sector responded with counter-cyclical measures, both in the economic and social sectors, trying to offset some of the negative impacts of the crisis on economic activity and employment and to cushion adverse effects on the population through labour market policies (LMPs), cash transfer programmes, public work schemes, food subsidies and investments in social infrastructure. These measures were partly financed through fiscal stimulus packages (see figure 10.1), with expenditure on social protection accounting on average for 25 per cent of stimuli (Zhang, Thelen and Rao, 2010). However, many countries moved towards fiscal tightening from 2010 onwards, with social sectors and pro-poor spending on health, education, social protection and agriculture suffering severe cuts (Kyril and Martin, 2010; United Nations, 2011a).

Developing countries have in many cases been more resilient to the most recent crisis than to previous ones, mainly due to improved fundamentals (debt,

financial sector, balance of payments, exchange rates and monetary indicators, foreign reserves) which are largely the result of strong growth over the mid-2000s, less exposure to global financial markets in the case of poorer African and Asian countries, some policy changes at the global and national levels, such as the debt relief granted through the Heavily Indebted Poor Countries (HIPC) Initiative, a reduction of public debt in selected middle-income countries, as well as expansion of social protection and production-oriented policies in selected countries (Ocampo, 2009; United Nations Conference on Trade and Development, 2010; Ferreira and Schady, 2009).

This notwithstanding, in the fifth year following the start of the crisis, effects are still visible and the global economy is struggling to get back onto a sustainable and inclusive growth track (World Bank, 2013; International Monetary Fund, 2012; United Nations, 2012).

The following section will focus on the issue of fiscal space and affordability of public policies, before presenting some evidence on how countries have mobilized and allocated funds and what the challenges for the future are.

Financing social and labour market policies: fiscal space and affordability

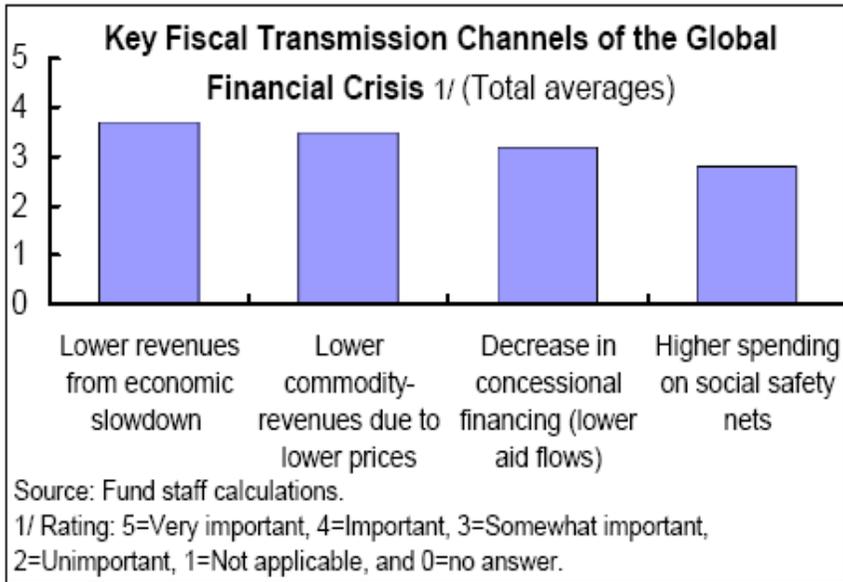
The availability of budgetary room to finance public policies in a sustainable way is labelled “fiscal space” (Heller, 2005). Fiscal sustainability implies that Governments are able to finance planned expenditures while honouring any debt obligations and ensuring solvency in the medium to long term.⁶⁵

In general, fiscal space depends on a country’s economic performance, including its capacity to produce income and savings and to generate government revenues; the performance of its domestic capital and financial markets; and the availability of external funding such as foreign investment, loans or grants. A dynamic economic environment and a stable world economy are therefore key determinants of healthy national public finances.⁶⁶

The global crisis has affected fiscal space negatively. Fiscal deficits rose sharply owing to falling revenues in combination with expenditure increases,

65 The literature on debt sustainability is vast—at a minimum, variables such as a country’s growth rate, exports, remittances, interest rates, revenue elasticities, composition of existing debt in terms of interest rates, maturity and currency denomination have to be taken into account. See Heller, 2005.

66 Mobilizing resources is, however, only part of the battle. Decisions about revenue policies and the allocation of public funds are the result of political processes, often dominated by elite groups. Consequently, such policies may not lead to the best outcomes in terms of providing public goods and reducing poverty. Furthermore, institutional capacity, including the quality and efficiency of public administration and service providers, influences how successfully resources are translated into social outcomes (see United Nations Research Institute for Social Development, 2010).

Figure 10.2: Fiscal transmission channels

Source: International Monetary Fund (2009:21).

as figure 10.2 illustrates. In order to create additional fiscal space for social policies (Millennium Development Goal (MDG)-related policies, or development enhancing policies more generally), two basic options stand out:

- (a) Reallocation of existing revenues;
- (b) Mobilization of additional revenues.

Reallocation or reprioritization of expenditure is usually the first option to look into for Governments aiming at a greater economic and social efficiency of public expenditures, especially in times where key economic, social or political variables change—for example, in the case of economic or political crisis or natural disasters, or changing demographics. The room for reprioritization is, however, limited in most countries, as a significant part of the budget is tied up in so-called non-discretionary spending (spending mandated by law, for example, social security spending—in contrast to discretionary spending that is decided annually by government and parliament). Reductions in public sector employment, wages or subsidies may entail significant political costs and are likely to be counterproductive with regard to employment goals and demand stabilization. In the case of aid-dependent countries, conditionalities on how to spend funds limit the space for discretionary government spending. In addition,

the following aspects have to be considered carefully in order to avoid immediate savings being offset by higher future costs:

- The cutting back of programmes in times of crisis can be costly over time, if expensive rebuilding of institutions and programmes is deemed necessary afterwards
- Efficiency gains through improved implementation of programmes (including programmes financed through aid, which can be costly due to donor coordination and conditionalities) are a long-term endeavour and can usually not be achieved in the short term or in a crisis situation
- Any reform has to consider any potential future liabilities and contingent costs as well as shifts in the maturity and sequencing of financial liabilities, which can have adverse effects on the short-term fiscal position of countries, triggering adverse market reactions⁶⁷

With regard to *mobilizing additional revenues*, the instruments used fall into the categories shown in table 10.1.

In a context of crisis, the potential for implementing structural reforms such as tax reforms, expansion of contributory systems or capture of a greater share of commodity production seems limited, at least in the very short term: Governments typically implement tax and contribution reductions and exemptions in a crisis with the objective of stabilizing production and employment levels, whereas commodity sectors such as oil and minerals tend to suffer from price declines in global markets.⁶⁸ Additional public borrowing, use of foreign reserves or sovereign funds, and foreign aid are the dominant instruments in a recession, although conditions with regard to access to credit and credit costs often deteriorate as well.

Finally, an important question is how to actually estimate or calculate fiscal space and fiscal affordability (taking into account both expenditures and revenues) for social policies, including labour market policies, in a particular country or country group. For this exercise, one approach is to compare national revenue and expenditure figures with international benchmarks; for example, how a country compares in terms of tax revenues or social expenditure (both level and

67 Privatization of public pay-as-you-go pension schemes illustrates the argument: long-term liabilities, the so-called implicit pension debt, is made explicit with immediate consequences for public debt and fiscal deficits (workers save their contributions on individual accounts and the State has to finance current pension expenditures through the general budget). See Arenas de Mesa and Mesa-Lago (2006) for the case of Chile, and Hujo (2004) for the Argentinian case and the link between pension reform and the breakdown of the currency board in 2001.

68 There is however, some evidence that reforms that are already under debate or part of a broader strategy can be accelerated by a crisis (the so-called benefit-of-crisis hypothesis); this happened, for example, with market-oriented reforms during the 1990s in Latin America and Eastern Europe, and with the expansion of social protection in Asia after the 1997 crisis.

Table 10.1: Mobilizing revenues – timing and conditions

Instrument	Short term potential	Medium to long term potential	Supporting conditions
Tax reform	Low	High	-Political support -Growth -State capacity -Growth of formal economy
Extension of contributory systems	Low	High	-Employment-intensive growth -Growth of formal economy -Organized labour force -State capacity -Insurance markets
Capture of mineral rents	Low	High	-State capacity (negotiation with foreign investors/management Dutch disease) -Rising commodity prices -Improved sector productivity -Strong public enterprise
Foreign aid	High	High	-Predictable and sustainable donor commitments -Global growth -Innovative funds and instruments -Management of Dutch disease effects
Domestic and external borrowing	High	High	-Economic stability -Interest rates and country risk -Access to international credit markets -Developed national capital markets/ financial sector -Debt sustainability/repayment capacity
Public private partnerships	High	High	-Higher private sector efficiency -Low risk of private sector insolvency

Source: Author's own elaboration.

composition) as a percentage of gross domestic product (GDP) with the average performance of countries within the same income group or region. If a country is significantly below the average, this is interpreted as an indication that there is room to increase tax efforts or to spend more on social policies.

A second approach is to compare actual spending on social protection with estimated costs of a basic social protection package (International Labour Organization, 2008) in order to determine whether additional social expenditures could be deemed affordable or whether the actual spending commitments match the costs of such a package (Bauer and others, 2010; Economic and Social Commission for Asia and the Pacific, 2011); similar costing models have been developed to assess necessary spending to attain the MDGs (Vos, Sánchez and Kaldewei, 2008) or for calculating the costs of specific programmes such as social pensions or other cash transfers.⁶⁹

Third, more detailed calculations of fiscal space or fiscal affordability of planned reforms take place at the country level, for example, as part of International Monetary Fund (IMF) or World Bank-supported programmes, taking into account the above-mentioned issues of debt sustainability, medium-term fiscal strategies and macroeconomic stability. Kyrili and Martin (2010) have developed a fiscal space index for International Development Association (IDA) countries in order to calculate how these countries could respond to decreased revenues in the current crisis context.⁷⁰ They assess the potential to borrow (domestically and externally), to mobilize additional domestic revenues such as taxation, and to mobilize more grants, taking into account additional indicators such as fiscal deficits and inflation. They find that more than half of the countries in the sample (54 low-income countries (LICs)) have no space to increase domestic revenue and more than half of the countries have already critical levels of debt, leading to their conclusion that scaling up of aid for the majority of countries which are not aid dependent is the preferred option.

The following two issues invite further thinking:

- First, fiscal space is a concept that has to be embedded in a specific country context, paying due attention to the country's economic, social and political structure.
- Second, costing models and debates on sustainable financing have problems in measuring economic and social costs and benefits that are not easily expressed in monetary terms or not easily estimated owing to the complexity of variables involved: What are the opportunity costs of not investing in decent work and social policies? How can indirect social costs of targeting or increased risk associated with market insurance

69 Organizations such as HelpAge International and the United Nations Children's Fund (UNICEF) have developed costing tools (see www.helpage.org and www.unicef.org).

70 The fiscal space index (Kyrili and Martin, 2010), first developed for the United Nations Educational, Scientific and Cultural Organization (UNESCO), draws on the fiscal space diamond developed by IMF and World Bank, and the United Nations Development Programme (UNDP) (Development Committee, 2006; Roy, Heuty and Leoutzé, 2007).

be measured? What are the distributional and developmental effects of tax reform and public borrowing? How can the risks of foreign debt or expansive fiscal policies in countries with weak monetary systems and currencies be calculated? What are the systemic costs for the global community of not delivering on aid commitments?

Finding answers to these questions requires moving beyond a crisis context to explore the issue of how to build sustainable and equitable financing systems for social protection and social development in normal times, to analyse the political economy of reform processes and budget allocations and to combine different methodologies for measuring fiscal space and the long-term costs and benefits of social policy.⁷¹

Thinking beyond a crisis context: social policies need sustainable and equitable financing⁷²

Distributional and developmental impact of revenue instruments

Which revenue instruments are best suited to generate sufficient funding while minimizing or avoiding negative consequences for production, redistribution and equity? From a point of view of social justice, more progressive financing instruments are preferable (in terms of redistributing resources towards lower income, disadvantaged or vulnerable groups) as they have a positive impact on solidarity and social cohesion.

From a macroeconomic perspective, the stabilization and growth effects of different revenue instruments are of interest. Progressive tax systems combined with transfer schemes are also known as automatic stabilizers, smoothing both boom and bust cycles.⁷³ Pension funds can be a source of finance, stimulating financial sector development and, in the case of occupational funds, providing “patient capital” (long-term financing) and wage moderation to firms, while supporting employment stability and incentives for workers to invest in industry-specific and/or firm-specific skills (Manow, 2001; Estevez-Abe, Iversen and Soskice, 1999).

71 UNRISD has conducted research on the issue of financing social policy aiming at a better understanding of the potential and constraints of different revenue sources and instruments such as taxation, social contributions and pension funds, remittances, mineral rents and aid. See United Nations Research Institute for Social Development (2010, chap. 8), Hujo and McClanahan (2009) and Hujo (2012).

72 This section draws heavily on chapter 8 of United Nations Research Institute for Social Development (2010).

73 The idea of automatic stabilizers goes back to the writings of J.M. Keynes, in particular his *General Theory* of 1936. For a more recent discussion from the perspective of the IMF, see Baunsgaard and Symansky (2009). The concept featured prominently in calls for fiscal stimulus measures in response to the crisis.

*Public revenues—options and constraints***Creating fair and efficient tax systems**

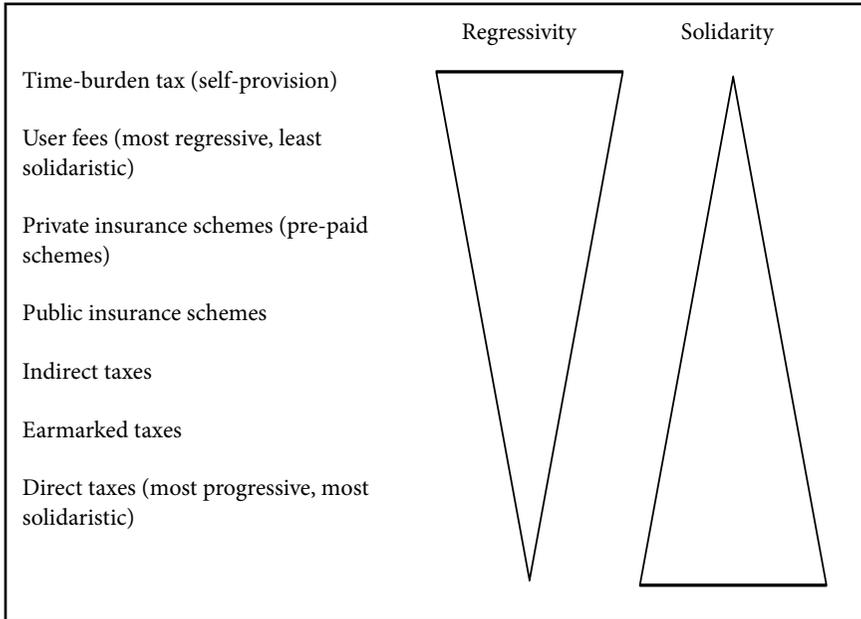
In developing countries, designing equitable and efficient tax systems is crucial to financing social policy in a context of consistent national development strategies and strong State–citizen relationships. The mobilization of domestic resources through tax reform was considered a key pillar of the 2002 Monterrey Consensus on Financing for Development and its follow-up Declaration in Doha in 2008 (United Nations, 2008), and it is recommended as the principal financing strategy (together with limited public and foreign borrowing, reallocation of funds and efficiency-enhancing measures) for Latin America and the Caribbean for achieving the MDGs (Vos, Sánchez and Kaldwei, 2008). Taxation revenue is generally deemed superior to other sources because of its stability and its potential for distributional justice and for financing programmes with universal coverage. Tax systems are also said to enhance State ownership and accountability compared to external revenues, which in the case of aid, for example, is tied to donor conditionality, therefore bypassing national constituencies and political institutions (Moore, 2004; Fjeldstad and Rakner, 2003; Bräutigam, Fjeldstad and Moore, 2008).

Tax reform, including more efficient tax administration and measures against evasion, remain key policy issues for most countries. The well-known challenges are to obtain higher tax receipts from high-income groups, property and asset owners, financial transactions, mineral rents and large commodity producers and environmentally damaging production. Di John (2008) recommends exploring alternative approaches for LICs, such as tariffs on commodity exports, land and property taxes, urban property taxes and agricultural marketing boards. At the global level, discussions continue on the potential and practicability of international taxes, global funds and reforms of the international financial architecture (United Nations, 2011b).

Contributory social insurance systems

Social insurance schemes are a common instrument for financing and providing social transfers. They can be initiated on a small scale and gradually extended to other groups of citizens as the formal economy expands. As with tax systems, the specific design of social insurance programmes matters, both in terms of financial stability, redistribution, equity, social cohesion and contribution to economic growth. Fiscal subsidies for social insurance schemes with limited coverage should be avoided, unless they are targeted to inclusion of difficult-to-cover groups such as informal workers or smallholders. With regard to extension of contributory insurance schemes in contexts where informality and poverty affect a considerable part of the population, innovative approaches, financial incentives and commitment of the State have contributed positively in the more successful cases.⁷⁴

74 See United Nations Research Institute for Social Development (2010, chap. 5), as well as International Labour Organization (2010a) for best practices in extension of social

Figure 10.3 Revenue type, distribution and social relations

Source: Based on Delamonica and Mehrotra (2009).

Mineral rents

For many developing countries, natural resource rents represent a substantial and growing proportion of total government revenues, either by means of taxation or royalty payments or direct ownership, with potentially enormous implications for the design and delivery of social policies. Mineral-rich countries are often said to suffer from a “resource curse”, a supposed correlation between natural resource abundance on the one hand, and a set of negative economic, political and social outcomes on the other (Sachs and Warner, 1995; Auty, 2001; Collier and Hoeffler, 2005). However, numerous resource-rich countries do not suffer from these symptoms, which points to the more interesting issue of explaining these variations in outcomes (Hujo, 2012).

One precondition for successfully tapping mineral wealth for social development is to avoid falling into the trap of “Dutch disease”. This requires macroeconomic policies that counteract inflationary pressures arising from the huge inflow of foreign exchange stemming from the mineral sector, with negative effects on stability and the competitiveness of manufacturing. Equally important are investments in infrastructure, such as electricity and transport, and in technologies that reduce the adverse environmental effects of mining. Lastly,

insurance in different country contexts.

improved taxation systems and contracts with private investors are crucial to ensure a fair share of income for the State (Stürmer, 2008).⁷⁵

Aid

International donors have agreed to substantially increase official development assistance (ODA) for LICs in order to accelerate the MDG process. And, although development assistance in the past has shown a procyclical pattern with regard to global economic boom and bust cycles, donors have promised to maintain ODA levels despite the recent economic crisis.⁷⁶ Aid is important not only in terms of financing social expenditure (and pro-poor economic infrastructure) in recipient countries, but also as an element of international justice and, as the case of the recent crisis demonstrates, of global stability (Ortiz, 2009; United Nations, 2011b).

Additional funding for poor countries can ease financial constraints. But, like rents from natural resources, aid flows are volatile, tend to parallel global and national economic trends, and pose a variety of challenges related to conditionality, accountability and the effects of Dutch disease, which have to be addressed successfully in order to make aid more effective for development.

Financing of labour market policies: country examples

Building on existing programmes and as part of fiscal stimulus packages, many countries have implemented or expanded LMPs and social protection measures such as conditional cash transfers (CCTs) or public works programmes. Tables 10.2 and 10.3 present policy tools and selected country evidence on policies implemented by Governments in developing countries as a response to the global crisis.⁷⁷ The portfolio of labour market responses to a crisis situation comprises reduction of working hours, on-the-job training, wage subsidies and reductions of social insurance contributions, public works, cash transfers and social assistance programmes, job search assistance, training programmes, entrepreneurship incentives and extension of unemployment benefits. However, not all of these

⁷⁵ See also the studies of United Nations Conference on Trade and Development (2010) on rent capture with regard to different minerals.

⁷⁶ According to the United Nations (2011a), total net ODA of Development Assistance Committee–Organization for Economic Cooperation and Development members has slightly increased, by 0.7 per cent in real terms in 2009, to US\$ 120 billion, although falling short of donor commitments made at the 2005 Group of Eight (G8) Summit in Gleneagles.

⁷⁷ Some measures are more costly than others, but also more rapidly effective and are therefore recommended for the short term (subsidies, benefit extensions, public works), whereas measures aimed at improving firm competitiveness, labour intermediation services, education and training and reformed benefit schemes are more appropriate for a long-term crisis scenario (Inter-American Development Bank, 2009).

Table 10.2: Labour market policies and potential funding sources

Policy tool	Financing source	Challenges/bottlenecks
Subsidized reduction in working hours (work sharing)	-unemployment insurance/funds -subsidies paid to employers (general revenues)	-can be costly for developing countries
Non-subsidized reduction in working hours	-employees might depend on safety net	-only applicable to formal sector -wages in developing countries on average too low to cut
On-the-job training	-government revenue -enterprises	-low capacity for training
Wage subsidies, cuts to employer social contributions	-government revenue -reserves of social security funds	-high costs, leakage, only for formal sector, problematic for social insurance funds
Public works, CCTs, social assistance	-government revenue -ODA	-widely used, but mixed success due to poor design and implementation -absence of social protection scheme, costly to establish
Job search assistance	-government revenue	-absence of institutions or skilled staff
Training programmes Work experience, apprenticeship programmes	-government revenue -ODA -enterprises -PPP	-programmes often underfunded, difficult to expand -improving effectiveness in informal economy
Entrepreneurship incentives (capital and skills)	-government revenue -ODA -private resources	-only few countries have existing programmes, not always effective
Extending unemployment benefits	-government revenue	-not applicable in countries without UB

Source: Based on table 1 in Cazes, Verick and Heuer (2009).

Table 10.3: Social policy and labour market responses to the crisis, selected countries

Country	LMP	
Argentina	<ul style="list-style-type: none"> -Public employment services: LM intermediation, training programmes -Expansion of Production Recovery Programme (REPRO): subsidized reduction in working hours; subsidy of 10% of labour cost for 12 months extendable by a further 12 months (at 5%). - Promotion of worker formalization (through incentives, e.g. pension moratorium) -wage increases for public sector employees - Plan to create 100,000 jobs (cooperatives: Plan Ingreso Social con Trabajo) 	<ul style="list-style-type: none"> -expansion non- -coverage expansion contributory par -public (employ plans Plan Fami (non-contributo
Brazil	<ul style="list-style-type: none"> -minimum wage adjustment -extension of unemployment benefit (2 months) 	<ul style="list-style-type: none"> -increase of Bols - expansion of B families (total co -housing progra Vida (cost 1.2%
Chile	<ul style="list-style-type: none"> -Employment subsidy for low-wage young workers, as well as additional cash transfers to low income households. Payment of US\$ 67 per families/individuals participating in social programmes, March 2009 -Extension of Unemployment Solidarity Fund to provide access for all unemployed workers -increase of minimum wage (2008) 	
Mexico	<ul style="list-style-type: none"> -The temporary employment programme at the federal level was expanded by 64% over what had been planned, bringing it up to US\$ 182 million in 2009. -US\$ 140 million earmarked under the Employment Preservation Programme for protecting employment in vulnerable businesses. -Support to unemployed urban workers (US\$ 110 per month) for a period of four to six months through the Urban Temporary Employment Programme. -minimum wage increase -support for workers in tourism -short-term training and capacity building SMEs 	<ul style="list-style-type: none"> -extended ability accounts for un -extension of he unemployed -Oportunidades (World Bank fin -nutrition progr
India	<ul style="list-style-type: none"> -increase in budget allocations for large flagship programmes for employment, education and health 	<ul style="list-style-type: none"> -Further extensi Guarantee Act (
South Africa	<ul style="list-style-type: none"> -Public investment programme -Expanded Public Works Programme (EPWP) 	<ul style="list-style-type: none"> -raising means-t programmes -age extension o -equalized mini pension

ountries (2008-2010)

Social protection	Financing
-contributory pensions -pension child benefits (current cost non- -port 0.55% GDP) - (ment) programmes Jefas, and follow-up - (lias, Training and Employment Insurance - (ry), Youth Work Programme	-government funds (including National Social Security Funds - nationalization of private pension funds in 2008: additional contribution flows 1.5% GDP p.a., accumulated pension stock ca. 10 % GDP; 30% of export tax on soy beans distributed to provinces) -World Bank loans
-Bolsa Familia value (CCT) -Bolsa Familia to an additional 1.3 million - (ost 0.4% GDP) - (programme 1 million units (Minha Casa, Minha - (GDP)	-FAT (Fundo de Amparo ao Trabalhador), might use up to 10% of its technical reserves -public debt -general revenues
	-Contingency Fund activated when unemployment rate rises above 10% (regional levels) -unemployment funds, unemployment solidarity fund -enterprises -general revenues
- (y to withdraw funds from retirement - (employed - (health coverage up to 6 months for - (CCT expanded by 1,500 million US\$ - (anced) - (programme	-loan World Bank and IDB -contingent credit line IMF, special drawing rights -government funds (including from oil revenue stabilization fund) -US\$ 6'000 million cut in public expenditure -private pension accounts -2010: tax reform, further expenditure cuts, price increases for fuel
- (ion of National Rural Employment - (cost approx. 0.6% GDP)	-NREGA: central government (wages, ¾ material) and states (1/4 material, unemployment allowance)
- (rest income threshold for social - (of child grant - (imum age for men and women for social	-Government Revenues -National Jobs Fund (contributions from Unemployment Insurance Fund, National Skills Fund)

are available or suitable for all countries, especially as some of them require certain labour market structures and institutions to be in place before the onset of a crisis, are costly or demanding in administrative terms, or are not suitable for workers in the informal economy. As table 10.2 shows, the funding sources for these measures include social insurance funds, general budget revenues, private resources (including from enterprises) and ODA.

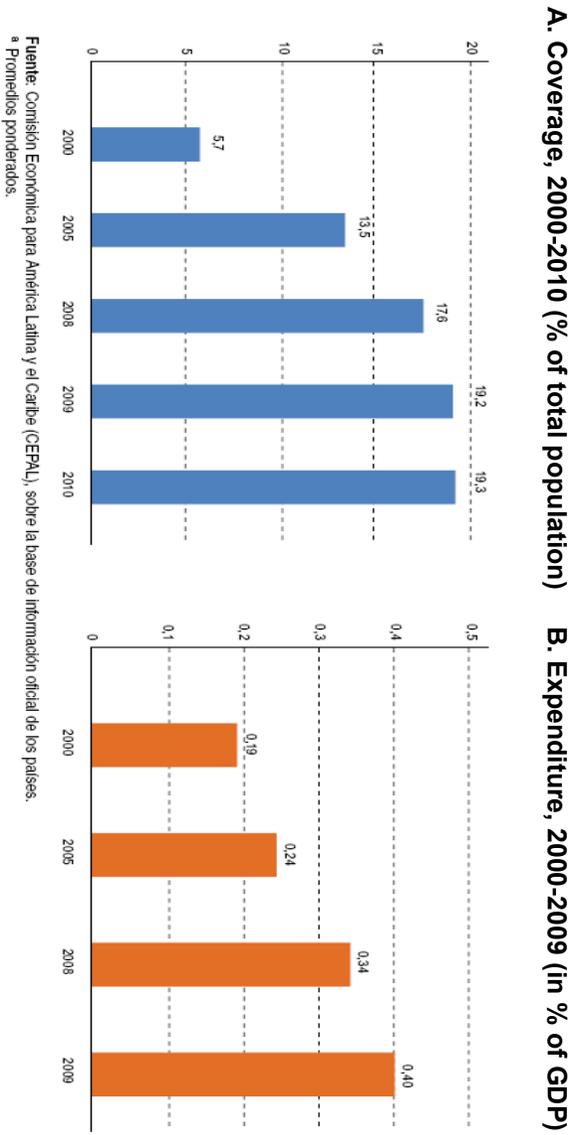
Where unemployment insurance is less developed, social assistance becomes the dominant social protection instrument for providing income support to vulnerable groups.

Latin America consolidated its position as a pioneer in cash transfer programmes, both social pensions as well as CCTs for families with children (transfers are conditional on school attendance and health check-ups for children). In 2010, CCTs covered almost 20 per cent of the region's population, as shown in figure 10.4.

CCTs exist in 19 countries in the region, covering more than 113 million persons or 19.3 per cent of the population (47.5 per cent of the poor), with expenditures of 0.4 per cent of GDP financed through national Governments and multilateral credit agencies such as the World Bank and the Inter-American Development Bank, and some bilateral donors (Economic Commission for Latin America and the Caribbean, 2010a). Income transfers, especially for lower income groups, have important multiplier effects and stimulate domestic demand and, by extension, employment (Berg and Tobin, 2011).

As table 10.3 shows, in addition to expanding CCTs as a crisis response, countries in Latin America have implemented a range of policies in support of labour markets and the unemployed (Freije-Rodríguez and Murrugarra, 2009; Economic Commission for Latin America and the Caribbean, 2010b). Social policy responses, including LMPs that were implemented in the countries, fall into the broad categories listed in table 10.3, but the specific policy mix in each country depends on the particular crisis impact, existing social programmes and institutions, the size of fiscal stimulus packages and fiscal space beyond the short term. Revenue sources and volumes vary also according to country context, with those countries depending on mineral rents, remittances, and trade revenues being most negatively affected. Access to domestic and external borrowing has been important in terms of funding fiscal stimulus measures, but some countries with less policy space in this area, for example Argentina, have resorted to exceptional measures (pension renationalization) that have increased fiscal space, whereas others (Chile) were able to make use of institutionalized anticyclical fiscal policy rules. In Latin America, as a result of the implemented measures in combination with the strong pre-crisis position and positive external demand for exporters, growth and employment levels recovered quickly (with Central America and the Caribbean still lagging behind), although, as stated above, some basic questions about medium-term implications of the crisis remain (Marinakakis, 2011; Ocampo, 2009). In Latin America and in other contexts where open unemployment is a

Figure 10.4: Latin America and the Caribbean: Coverage of CCT and related public expenditure



Source: Comisión Económica para América Latina y el Caribe, 2010a: Graph III.7 (19 countries)

deeply entrenched structural problem (e.g., in South Africa) or where informality is the reality for a substantial part of the population (India and many LICs), the challenge is to move towards a more inclusive growth model, with less residual and fragmented social policies and more integrated labour markets that provide decent work.

Conclusions and policy implications

In the current global context marked by a continued crisis in the euro zone and decreasing growth projections in other regions, there is a continued need to boost economic growth and to invest in employment and social protection. At the same time, many countries seem to have exhausted their fiscal space to fund these measures and have prematurely cut expenditures. If there is some truth in the argument of a benefit of crisis, the recent experience should encourage policymakers to advance further in institutionalizing social and labour market policies and progressive financing systems. In order to support return to a sustainable growth path, more funds have to be allocated to economic and social policies that foster employment and protect household income. It is also worth mentioning that fiscal constraints do not justify countries not securing certain minimum standards in terms of social security as enshrined in the international human rights framework and other conventions (International Labour Organization, 2010a; Sepúlveda Carmona, 2011).

The following paragraphs summarize some fundamental lessons with regard to financing labour market and social policies in times of crisis and beyond.

Financing policies have a political and social dimension

Revenue policies and budget processes are part of complex political and social processes. The more democratic, accountable and transparent the political process, the more likely these will reflect the public interest and combine economic and social goals. In times of crisis, hard choices have to be made and the immediate need to stabilize the financial economy often works to the detriment of social policies and employment concerns. It is therefore important that international organizations and civil society actors continue to alert policymakers to the fact that the economic, social and political costs of this neglect can be enormous.

Financing policies have distributional effects

The way in which social expenditure is financed is not neutral in its distributional or productive effects. Reforms entail potential losers and winners, which may or may not correspond to groups benefiting from public transfer schemes and social investments. The macroeconomic effects of different financing sources, such as the impact on domestic demand, investment and savings, monetary stability and currency risks, have to be considered carefully. Similarly, the implementation of

progressive direct taxes on wealth and income tends to create opposition from influential social groups and can lead to reform blockades. Therefore, the more universal social programmes are, the easier it is to find convincing arguments for progressive funding structures, which are built on relatively greater contributions from higher income groups.

Anchor a country's social policy system with domestic sources of financing

External sources of funding, in particular ODA, are only sustainable as long as donor commitments last. Internal sources, such as tax revenues or social contributions/funds, if designed effectively, have the potential to create intergenerational and interclass linkages that are more difficult to break over the long term. These domestic financing structures are the core or the anchor of social policy systems. Domestic financing instruments are levied on national economic activity and they redistribute income and risks among different groups. Macroeconomic policies that foster income creation and decent, formal employment are therefore central to any successful fiscal strategy.

Develop a clear strategy for financing social policies

A strategy for financing social policies should build on reliable calculations of the estimated costs of planned programmes over longer periods and take into account different scenarios. It is important that Governments evaluate different financing techniques and assess their pros and cons from a political, economic and social point of view; analyse any relevant experiences in other countries; and seek early dialogue with relevant stakeholders, including social and finance ministries, external donors, international organizations, social partners and civil society organizations; and last, but not least, include a contingency plan for a crisis situation.

Avoid costly short-term measures and plan for the future

Many developing countries are actually living in a situation of permanent crisis or crises, which has major negative implications for sustainable and equitable long-term development. This crisis should not be used (as has happened in the past) to justify measures with adverse long-term consequences for State capacity, poverty reduction and social development; to the contrary, it should pave the way for more inclusive economic and social policies.

References

- Auty, Richard M. (ed.) (2001). *Resource Abundance and Economic Development*. Oxford University Press: Oxford.
- Arenas de Mesa, Alberto, and Carmelo Mesa-Lago (2006). The structural pension reform in Chile: Effects, comparisons with other Latin American reforms, and lessons. *Oxford Review of Economic Policy*, vol. 22, No. 1, pp. 149–167.
- Bauer, Armin, David E. Bloom, Ocelyn E. Finlay and Jaypee Sevilla (2010). Global crisis and fiscal space for social protection. *Poverty and Sustainable Development in Asia: Impacts and Responses to the Global Economic Crisis*, Armin Bauer and M. Thant (eds.). Asian Development Bank, pp. 257-274.
- Baunsgaard, Thomas, and Steven A. Symansky (2009). Automatic fiscal stabilizers. IMF Staff Position Note, SPN/09/23, Washington, D.C.: International Monetary Fund.
- Berg, Janine, and Steven Tobin (2011). Income-led growth as a crisis response: Lessons from Brazil. Paper prepared for the ILO Research Conference on Key Lessons from the Crisis and Way Forward, 16 and 17 February 2011. Geneva: International Labour Office.
- Bräutigam, Deborah, Odd-Helge Fjeldstad and Mick Moore (eds.) (2008). *Taxation and State-Building in Developing Countries: Capacity and Consent*. Cambridge: Cambridge University Press.
- Cazes, Sandrine, Sher Verick and Caroline Heuer (2009). Labour market policies in times of crisis. ILO Employment Working Paper No. 35. Geneva: International Labour Office.
- Collier, Paul, and Anke Hoeffler (2005). Resource rents, governance and conflict. *Journal of Conflict Resolution*, vol. 49, No. 4, pp. 625–633.
- Delamonica, Enrique, and Santosh Mehrotra (2009). How can financing of social services be pro-poor? *Financing Social Policy: Mobilizing Resources for Social Development*, Katja Hujo and Shea McClanahan (eds.). Basingstoke: UNRISD/Palgrave Macmillan.
- Development Committee (2006). Fiscal policy for growth and development: An interim report. Washington, D.C.: International Monetary Fund and World Bank. Available from [http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003\(E\)-FiscalPolicy.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003(E)-FiscalPolicy.pdf) (accessed 14 June 2011).
- Di John, Jonathan (2008). Fiscal reforms, developmental state capacity and poverty reduction. Background paper for the United Nations Research Institute for Social Development report on *Combating Poverty and Inequality*.

Economic Commission for Latin America and the Caribbean (2010a). *Panorama Social de América Latina 2010*. Santiago de Chile: ECLAC.

_____ (2010b). La reacción de los gobiernos de las Américas frente a la crisis internacional: una presentación sintética de las medidas de política anunciadas hasta el 31 de diciembre de 2009. Available from <http://www.eclac.org/publicaciones/xml/8/35768/2009-192-LareacciondelosgobiernosdelasAmericas-pos31marzo2009.pdf>. (accessed on 26 May 2011).

Economic and Social Commission for Asia and the Pacific (2011). *The Promise of Protection: Social Protection and Development in Asia and the Pacific*. Bangkok: ESCAP.

Estevez-Abe, Margarita, Torben Iversen and David Soskice (1999). Social protection and the formation of skills: A reinterpretation of the welfare state. Paper presented at the 95th American Political Association Meeting, Atlanta, 2–5 September.

Ferreira, Francisco H.G., and Norbert Schady (2009). Social consequences of the global financial crisis in Latin America: Some preliminary, and surprisingly optimistic, conjectures. LCR Crisis Brief, World Bank. November.

Fjeldstad, Odd-Helge, and Lise Rakner (2003). *Taxation and Tax Reforms in Developing Countries: Illustrations from Sub-Saharan Africa*. CMI Report No. R 2003:6. Bergen: Chr. Michelsen Institute.

Freije-Rodríguez, Samuel, and Edmundo Murrugarra (2009). Labor markets and the crisis in Latin America and the Caribbean: A preliminary review for selected countries. LCR Crisis Brief (June). Washington, D.C.: World Bank.

Heller, Peter S. (2005). Understanding fiscal space. IMF Policy Discussion Paper No. PDP/05/04. Washington, D.C.: International Monetary Fund.

Hujo, Katja (2004). Reforma previsional y crisis económica: El caso Argentino. *Públicos o privados? Los sistemas de pensiones en América Latina después de dos décadas de reformas*, Katja Hujo, Carmelo Mesa-Lago and Manfred Nitsch (eds.). Caracas: Nueva Sociedad, pp.135-174.

_____ (ed.) (2012). *Mineral Rents and the Financing of Social Policy: Opportunities and Challenges*. United Nations Research Institute for Social Development/Palgrave.

Hujo, Katja, and Elena Gaia (2011). Guest Editorial. Social policy and poverty: An introduction. Special Issue *International Journal of Social Welfare*, vol. 20, No. 3, pp. 230-239.

Hujo, Katja, and Shea McClanahan (eds.) (2009). *Financing Social Policy: Mobilizing Resources for Social Development*. Basingstoke: United Nations Research Institute for Social Development/Palgrave Macmillan.

- Inter-American Development Bank (2009). *Social and Labor Market Policies for Tumultuous Times*. Washington, D.C.: IADB.
- International Labour Organization (2008). Can low-income countries afford basic social security? Social Security Policy Briefings, Paper 3. Geneva: International Labour Office.
- ____ (2009a). *Recovering from the Crisis: a Global Jobs Pact*. Geneva: International Labour Office.
- ____ (2009b). *The Financial and Economic Crisis: A Decent Work Response*. Geneva: International Labour Office.
- ____ (2010a). *Extending Social Security to All. A guide through challenges and options*. Geneva: International Labour Office.
- ____ (2010b). South Africa's response to the crisis. ILO G20 Country Briefs, prepared for G20 Labour and Employment Ministers, 20 and 21 April 2010. Washington, D.C.
- International Monetary Fund (2009). *The Implications of the Global Financial Crisis for Low-Income Countries*. Washington, D.C.: International Monetary Fund.
- ____ (2012). World Economic Outlook Update. International Monetary Fund, Washington, D.C. July.
- Kyrili, Katerina, and Matthew Martin (2010). *The Impact of the Global Economic Crisis on the Budgets of Low-Income Countries*. Oxfam Research Report. July.
- Manow, Philip (2001). Globalization, corporate finance, and coordinated capitalism: Pension finance in Germany and Japan. Working Paper No. 01/5, MPIfG. Cologne: Max Planck Institute for the Study of Societies.
- Marinakakis, Andrés (2011). Explaining Latin America's robust recovery from the crisis. Paper prepared for the ILO Research Conference on Key Lessons from the Crisis and Way Forward, 16 and 17 February 2011. Geneva: ILO.
- McCord, Anna (2010). The impact of the global financial crisis on social protection in developing countries. *International Social Security Review*, vol. 63, No. 2, pp. 31-45.
- Mesa-Lago, Carmelo (2009). *Efectos de la crisis global sobre la seguridad social de salud y pensiones en América Latina y el Caribe y recomendaciones de políticas*. CEPAL serie políticas sociales No. 150, Santiago de Chile: ECLAC.
- Moore, Mick (2004). Revenues, state formation, and the quality of governance in developing countries. *International Political Science Review*, vol. 25, No. 3, pp. 297-319.

- Ocampo, José Antonio (2009). Latin America and the global financial crisis. *Cambridge Journal of Economics*, No. 33, pp. 703-724.
- Ortiz, Isabel (2009). Fiscal stimulus plans: The need for a global New Deal. International Development Economics Associates, IDEAs. March 2009 Available from http://www.networkideas.org/news/mar2009/news18_Fiscal_Stimulus_Plans.htm (accessed 10 June 2011).
- Roy, Rathin, Antoine Heuty and Emmanuel Letouzé (2007). Fiscal space for what? Analytical issues from a human development perspective. United Nations Development Programme, paper prepared for the G20 Workshop on Fiscal Policy, Istanbul, 30 June to 2 July 2007. New York: UNDP.
- Rial, Noemí (2009). La crisis mundial y la experiencia argentina. *Revista del Trabajo*, vol. 5, No. 7, July-December 2009, pp. 175-184.
- Sachs, Jeffrey D., and Andrew M. Warner (1995). Natural resource abundance and economic growth. NBER Working Paper No. 5398. Washington, D.C.: National Bureau of Economic Research.
- Sepúlveda Carmona, Magdalena (2011). Report of the Independent Expert on the question of human rights and extreme poverty for the 17th Session of the Human Rights Council, United Nations document A/HRC/17/34. 17 March 2011.
- Stürmer, Martin (2008). Financing for Development Series: Increasing Government revenues from the extractive sector in Sub-Saharan Africa. DIE Briefing Paper No. 9. Bonn: German Development Institute.
- United Nations (2008). Doha Declaration on Financing for Development: Outcome document of the follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus. United Nations document A/CONF.212/7, chap. 1, res. 1.
- ____ (2011a). *The Global Social Crisis. Report on the World Social Situation 2011*. New York: United Nations.
- ____ (2011b). *World Economic Situation and Prospects 2011*. New York: United Nations.
- ____ (2012). *World Economic Situation and Prospects 2012*. Update as of mid-2012. New York: United Nations.
- United Nations Conference for Trade and Development (2010). *Trade and Development Report. Employment, globalization and development*. Geneva.
- United Nations Research Institute for Social Development (2010). *Combating Poverty and Inequality: Structural Change, Social Policy and Politics*. Geneva.
- Utting, Peter, Shahra Razavi and Rebecca Varghese Buchholz (eds.) (2011). *The Global Crisis and Transformative Social Change*. UNRISD/Palgrave.

Vos, Rob, Marco V. Sánchez and Cornelia Kaldewei (2008). Latin America and the Caribbean's challenge to reach the MDGs: Financing options and trade-offs. DESA Working Paper No. 68. New York: United Nations.

World Bank (2009). *Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis*. Washington, D.C.: World Bank.

____ (2013). Assuring Growth over the Medium Term. *Global Economic Prospects*, vol. 6 (January 2013). Washington, D.C.: World Bank.

Zhang, Yanchun, Nina Thelen and Aparna Rao (2010). Social protection in fiscal stimulus packages: Some evidence. A United Nations Development Programme/Office of Development Studies Working Paper. New York: UNDP.

Chapter 11

Crisis-driven labour market programmes: the experience of Latin America and the Caribbean

JACQUELINE MAZZA AND DANILO FERNANDES LIMA DA SILVA

Introduction

Latin America and the Caribbean (LAC) are no strangers to economic shocks, natural disasters or financial crises. During the most recent financial crisis of 2008-2010, the region showed a striking resilience in comparison with other developing countries that suffered much greater employment effects.

Despite the region's experience with dramatic economic downturns, it is still developing the core labour market programmes and policies both to better weather future crises and to promote productivity growth. This chapter examines key labour policy experiences of the LAC region in response to crises, with a particular emphasis on the recent crisis of 2008-2010.⁷⁸ Since unemployment insurance is relatively rare in the region, the chapter focuses on the adaptation of active labour market policies—the principal LAC policy response—along with the innovations and adaptations made to existing unemployment insurance, so-called passive policies. Much of the evidence regarding programme results during the recent crisis, however, is still anecdotal. The chapter argues in favour of the need for a more systematic and rigorous set of programme evaluations, examining the targeting, timing and outcomes of crisis-driven programmes to support the region's responses to future crises. The chapter concludes that Governments in the region should use evidence produced during crises more strategically to build

78 The chapter draws on an earlier work by the Inter-American Development Bank team, "Social and Labor Policies for Tumultuous Times" (Duryea, Mazza and Regalia, 2009).

long-term institutional capacity and a more permanent and productive set of active and passive labour market policies.

Social and labour policy responses to the crisis in Latin America and the Caribbean

Specific transmission and policy channels for the LAC region

LAC suffers from higher income and asset inequality than other developing regions. It has suffered as well from stagnant labour productivity growth, low savings rates, high levels of labour informality (in key countries) and an education system that does not deliver quality education. The informal sector tends to grow during crises, with low-productivity work serving as a response to unemployment. These problems affect the nature and intensity of shocks in the region and should be taken into consideration in devising policy responses.

Only a few countries in LAC have unemployment insurance or emergency labour assistance programmes to smooth consumption spending during periods of high unemployment. Unemployment insurance programmes are largely in the higher-income South American countries, Chile being the one with greatest coverage. Argentina, Brazil, Colombia and Uruguay are the other South American countries that can count on unemployment insurance programmes to buffer formal sector job losses. Barbados is the only Caribbean country with unemployment insurance. Mexico does not have such a programme, nor does any country in Central America.

When the recent crisis hit the region, most countries had already established national conditional cash transfer (CCT) programmes. This provided a floor for structural, long-term poverty, but it is not a policy instrument designed for the “newly poor”. These programmes provide the very poor with income supplements conditioned on keeping school-age children in school and maintaining health check-ups. In some countries, the current CCT programmes include only a fraction of the chronically poor population. Whereas CCT programmes have been shown to be effective in addressing issues of structural poverty, they serve merely to maintain consumption levels in the face of an aggregate shock. These programmes do not have administrative mechanisms to rapidly and accurately assess the eligibility of the newly poor, nor would those newly poor who still have assets qualify.⁷⁹ Argentina, Brazil, Costa Rica, El Salvador and Paraguay are among the countries that expanded either the number of beneficiaries and/or the value of the transfers during the most recent crisis.

Other instruments such as targeted food stamps and self-targeted temporary employment programmes more typically provide income support in response to

79 CCTs typically target according to a household’s assets rather than the current income flow, with eligibility checked every two to three years

a crisis of short duration in the absence of other forms of insurance. Temporary employment programmes and on-the-job training (both adult and youth) have formed the bulk of the more specific labour programme responses to crises in the region, as discussed in detail in the section on the LAC experience with crisis-driven labour market programmes.

Many labour ministries in the region are making advances in institutional capacity-building to launch more extensive active labour market policies, particularly improvements of national employment services (e.g., job finding and brokering services), demand-based training systems and skills standards/certification. However, these ministries, especially those in the poorer countries, have limited resources, personnel and programme experience that constrain institutional advances. Institutional advances of labour ministries and of labour policies, this chapter concludes, lie at the heart of improving both the speed and quality of labour responses to future crises. Thus, the ability to respond to short-term employment crises and the strengthening of the capacity of labour ministries are complementary goals in or out of a crisis.

How the recent crisis affected LAC economies

There are a number of reasons why the most recent crisis did not affect poverty as much as previous crises had, including overall macroeconomic conditions and the concentration of job losses among formal sector workers. During the crises of the 1990s, poverty increased by 7 percentage points from 1994 to 1996 in Mexico and by 8 percentage points in Argentina from 1993 to 1995 (Lustig, 2000). In contrast, it is estimated that poverty increased by only 0.1 per cent in the region, on average, between 2008 and 2009 and that it decreased by 1.6 per cent between 2009 and 2010, although these numbers obscure the more heterogeneous impacts of the crisis in different countries and sectors (Economic Commission for Latin America and the Caribbean, 2011). Moderate poverty actually decreased by 5.8 percentage points in Argentina once the recovery started (2008-2010), and it increased by 3.5 per cent on average in Mexico during the same period (Socio-Economic Database for Latin America and the Caribbean, 2012).

Overall, the largest employment impacts were felt in those countries with the greatest integration into United States markets (Mexico, and Caribbean and Central American countries). Key sectors in these countries were affected either by declines in trade or commodity prices—auto manufacturing, tourism, agriculture, mining—or via a slowdown in remittance flows. Gross domestic product (GDP) slowed throughout the region, on average by 1.9 per cent in 2009 following an expansion of 4.1 per cent in 2008 (World Bank, n.d.). Mexico suffered the biggest contraction with a 6.2 per cent GDP decline (ibid.), its worst performance in 70 years, from the combination of trade and manufacturing contractions along with tourism losses from the H1N1 influenza outbreak. In the early stages of the

crisis, unemployment was registered principally in the export-dominated sectors (e.g., automobiles, agriculture and mining) and tourism. On a country basis, disproportional impacts can be seen in formal sector employment in the mining sectors (e.g., Chile and the Dominican Republic), textiles and apparel (e.g., the Dominican Republic, El Salvador and Honduras) and the auto industry (e.g., Argentina and Mexico).

More stable macroeconomic conditions contributed both to a smaller immediate impact of this latest crisis (relative to the 1990s) and to the ability to recover. An analysis by Banco de España found that Latin America learned from past crises and pursued sounder monetary and fiscal policies, including more flexible (managed) exchange rates and fewer regulations on excessive capital controls (Gallego and others, 2010). Latin America's sounder economic fundamentals were supported by stable commodity prices, aiding the relatively shorter-term impact of the crisis (Council on Foreign Relations, 2008; Izquierdo and Talvi, 2009). The International Monetary Fund (IMF) concluded that this stronger macroeconomic framework was a key factor in the smaller impact of the crisis in Latin America relative to past crises (International Monetary Fund, 2010).

While employment losses in the United States of America fell disproportionately on male workers in the manufacturing sector, the impacts were felt disproportionately by female workers in manufacturing sectors in LAC. In 2008 in Mexico, 71 per cent of all workers laid off were women (Mazza, 2009). Similarly, in Honduras, where employment losses were concentrated in the heavily female textile (*maquila*) sector, 70 per cent of jobs lost through February 2009 (29,000 jobs) were those of female workers.

In previous Latin American crises (e.g., the peso crisis of 1994), outmigration to Organization for Economic Cooperation and Development (OECD) countries and increased remittance flows back to the region functioned as important safety valves. As the 2008 recession originated in the United States and Europe, these markets were contracting and limited the ability of outmigration to serve as a labour crisis response. There was a drop off in the value of remittances to the region from 2008, largely due to exchange rate effects and employment losses from migrants in sending countries. By 2011, remittances began to grow again, but even at \$61 billion they have not climbed back to the level reached just before the crisis (\$64 billion in 2008) (Multilateral Investment Fund, 2011). The limited evidence available indicates the crisis did not lead to a substantial increase in the number of migrants leaving the region or returning. There was clearly a sharp decline in Mexican migration to the United States noted in the 2008-2009 period (Organization of American States, Organization for Economic Cooperation and Development and the Economic Commission for Latin America and the Caribbean, 2011). The United States also reported that border apprehensions fell by almost two fifths between 2007 and 2009, even as border patrols increased (Department of Homeland Security, 2010). Countries did not report an increase

of return migration, with the exception of small countries such as those affected more by the Spanish crisis. Ecuador reported that for every four migrants who left the country from 2001-2010, one returned home (Mosquera, Moncayo and Escobar García, 2012). Mexico's 2010 census, in contrast, reported only 1.5 per cent of Mexicans were return migrants, in contrast to 8 per cent in 2000, and the majority of the return migrants were older men (Campos-Vasquez and Sobarzo, 2012).

Latin American and Caribbean experience with crisis-driven labour market programmes

LAC countries responded to the crisis by making adjustments to current active or passive labour market policies, or by creating new temporary programmes. The LAC response required more new programming and attention than that of developed countries which benefited from both automatic policy “stabilizers” such as unemployment insurance and larger fiscal resources to devote to stimulus spending. Like many developing countries, LAC Governments work more at the policy margins, making refinements and adding instruments where they can.

The following section discusses the range of specific employment policy options implemented in LAC that have been both developed and adapted in crisis contexts. It draws on the experiences of not only the most recent financial crisis but also prior crises, which were often more severe in terms of employment effects. The section discusses immediate actions and those that are intended to support a more permanent labour policy framework. These policies often respond to three key policy objectives: to protect the most vulnerable, to prevent irreversible impacts and to respond in a consistent manner.

Immediate actions addressing employment, benefits and labour costs

Training and wage subsidies

Long-term and classroom-based labour training (more than one year, typically for the non-poor) has a very mixed record in getting the structurally unemployed back into the marketplace. Short-term training, however, if it is done “on the job” (OJT), has a much stronger record in getting the unemployed re-employed and upgrading existing worker skills (Ibarrarán and Rosas Shady, 2008), and has been shown to be adaptable to LAC employment crises. In the 2008-2009 crisis, Honduras and Mexico, in particular, drew on OJT both to keep workers employed and to provide income to unemployed workers with the possibility of future employment. For employed workers, such training (two to six months long, typically) acts, in

effect, as a wage subsidy, as the employer receives a training subsidy from the Government for the worker's salary (e.g., typically, 1-2 minimum salaries). OJT is typically a better adaptation to a crisis than a wage subsidy because its temporary nature does not distort salaries or incentives within the firm and can be targeted easily by region, industries or job level. In addition, it can be targeted to the sectors where there is a fear of large job loss. There is even more international and LAC experience for OJT as a form of inserting unemployed workers into new jobs (Gonzalez-Velosa, Ripani and Rosas Shady, 2012). In times of crises, these training programmes are scaled up and targeted to areas or sectors of high unemployment. If the crisis persists to the medium term, however, OJT to support increased labour insertion of the unemployed is much less viable, e.g., it will be harder to get employers to agree to employ trainees after the traineeship period if firm viability is in question.

A number of countries in the region, including Argentina, Chile, Mexico and Uruguay (Marinakís and Velásquez, 2010), used a combination of training and wage subsidy instruments to retain workers on the job during the last set of crises. Wage subsidies were the principal instrument, sometimes complemented with days of training. Peru enacted a nationwide free training programme for those who lost their jobs in the 2008-2010 period, called *Revalora Peru*. Beneficiaries must register at one of the local offices of the Labour Ministry. Since 2009, 50,000 people have been trained. An impact evaluation has not been conducted on the programme, which continues in the post-crisis period (and is now named *Vamos Peru*).

Temporary employment and public works

Temporary employment programmes were common prior to the financial crisis, probably due to the scarcity of non-crisis labour market programmes, unemployment insurance or anti-poverty instruments. Temporary employment (short-term jobs where resources are principally directed to salaries) and public works (fiscal stimulus projects that indirectly are intended to create short-term jobs) were used by some LAC countries in the recent crisis, as well as by countries in East Asia and Eastern Europe. Temporary employment programmes are best targeted to the very poor so as to maintain consumption during the worst points of a crisis, typically a period of 3-6 months. If pure income transfer or consumption smoothing is the goal, then other safety net interventions would likely yield more income transferred per worker. As a labour market instrument, temporary employment has had, at times, negative labour market effects in both the short and medium terms (Kluge, 2006) and has in some cases impaired, rather than improved the ability of recipients to get employment after the temporary programme. However, such employment programmes have also been shown to be effective in helping mitigate income shocks (Ninno, Subarao and Milazzo, 2009). Public works projects rarely focus on maximizing employment per dollar spent, but are justified in crisis times as they generate short-term jobs at high- and

low-income levels in construction and services.

Latin America has had experience in temporary employment dating back to Chile's 1975 Minimum Employment Programme (Economic Commission for Latin America and the Caribbean, 2006), the Plurinational State of Bolivia's *Plane* programme, as well as experiences in Argentina, Colombia and Mexico. In the most recent crisis, Mexico and Peru implemented temporary employment programmes and previously utilized public works instruments. Administrative capacity to quickly launch such programmes is key. In Latin America, temporary employment programmes have been generally administered by government agencies; in contrast, countries in East Asia have at times contracted temporary employment jobs to private or non-profit firms. Latin America has struggled to keep these programmes temporary, as political pressures have led many of them to have more permanent status, albeit at lower levels of operation. Overall, the region has experienced substantial lag times to get programmes running, missing the crisis period only to be inaugurated after recovery has begun (Reinecke, 2005). Argentina's programme *Jefes y Jefas de Hogares* (Heads of Household) offers a good example of the risks of keeping a crisis-focused programme running after the crisis. Although it was a well-designed programme that made a significant impact during the relevant crisis, it was expanded in the post-crisis period, and targeting to the very poor was loosened as was the link to employment (Galasso and Ravallion, 2003; Kostzer, 2008).

Temporary extensions of health, pension and unemployment insurance

During the most recent crisis, a number of Latin American countries more readily used adjustments to existing labour benefit programmes to provide supplemental income or reduce labour costs than had been seen in previous crises. Southern Cone countries, in particular, extended health benefits to laid-off workers to support a social safety net during the crisis. Chile took actions to protect the pension contributions of older, now unemployed workers close to retirement.

The few unemployment insurance systems in place in the region, all with limited scope, were put to work and adapted to the crisis. Unemployment insurance systems in Latin America, in general, are for much shorter durations and lower levels of income replacement than their OECD counterparts. In past crises, even these small coverage systems were overwhelmed by the demands of higher levels of unemployment, and benefit levels were reduced from low levels (via shortened periods of time, increased requirements for eligibility) even while fiscal costs rose (Mazza, 1999). Box 11.1 shows adaptations of Brazil's, Chile's and Uruguay's existing unemployment insurance programmes.

Chile incorporated benefit changes within a wider strategy that included linking training to employment-retention criteria. In addition to the adaptations of its unemployment insurance and fiscal incentives of up to US\$ 4 billion (2.8 per cent of GDP), Chile achieved agreement on a National Agreement for Employment,

Box 11.1**Adapting unemployment insurance: Brazil, Chile, and Uruguay**

Brazil, Chile and Uruguay tested and adapted changes in their unemployment insurance programmes to better respond to the financial crisis. Before the crisis struck, these countries had already been considering an extension to the length and modality of benefits if a certain unemployment level was reached, or if the country entered into an economic recession (Velásquez, 2010). As the crisis hit, Brazil and Chile extended the length of unemployment benefits by two months for workers in hard hit sectors. In Brazil, almost 310,000 workers received the benefit for seven months (the maximum allowed) (International Labour Organization and International Institute for Labour Studies, 2011). In Uruguay, officials permitted employers to use the unemployment insurance system to temporarily suspend workers contracts for up to six months. The mechanism was widely used and allowed thousands of workers to go back to their jobs after the sharpest moment of the crisis (Velásquez, 2010).

Uruguay, which has not been greatly impacted by the financial crisis, concentrated its efforts on expanding and adapting unemployment insurance. Unemployment insurance has been used on a temporary layoff basis, relaxing rules on rehiring. There is evidence that many employers did not fire their employees because of such insurance and some employees continued working while others were temporarily covered by insurance before going back to their previous job (Velásquez, 2010).

Training and Labor Protection (Acuerdo Nacional por el Empleo, la Capacitación y la Protección Laboral), a programme that provided training incentives to employers to allow their employees to take up to five months of government-paid training with the condition that these employers would not be fired after this period.

Systematic measures to support employment and human capital development

Not all labour policy responses in the region have been of a temporary nature. In some cases, economic crises have provided the political moment for reforms and consensus or policy experimentation that was not possible before. They have also provided opportunities to expand capacity for labour market programmes, such as in the case of Mexico's National Employment Service, which grew into one of the region's strongest national networks of employment offices after delivering responses to economic crises in 1992, 1994 and 2008-2009 (Mazza, 2011).

Restructuring and implementing labour benefit systems: pensions, severance pay and unemployment insurance

Pension systems in the region are still relatively rare and most provide relatively low levels of national coverage and defined benefits. Unemployment insurance programmes are also relatively rare. Calculations by the Inter-American Development Bank estimate that only 5 per cent of the unemployed in Latin America

were covered by unemployment insurance programmes in 2009, compared with 66 per cent in the United States.⁸⁰ Creating such programmes in a crisis can be administratively difficult although a crisis can prompt political attention to both the creation of more permanent benefit programmes and improvements to protect the solvency. The inability to make severance payments provided a critical moment in Barbados to enact an unemployment insurance programme which provided a system of more secure payments for workers' overtime (Mazza, 1999). This most recent crisis posed greater challenges to portfolio-based benefit systems, such as pension systems, given the simultaneous unravelling of key financial institutions and investments.

Twelve LAC countries have implemented mandatory pension systems in the past two decades, shifting pensions from social (public) to individual responsibility, with the expansion of private pension systems as well. The pressures of the most recent crisis have put a spotlight on the need for fundamental reforms and restructuring of many pensions systems, aiming at making them sustainable and expanding their coverage under difficult financial circumstances. Only three pension systems in the region are "multi-funds", that is, they reduce risk to pensioners by shifting the asset allocation over time to progressively less risky investments as the pensioner ages. In preparation for future crises, pension solvency, flexibility and coverage will be at the forefront of insuring that future downturns do not continue to put retiring populations at great risk; as will the use of unemployment insurance schemes to adapt and stabilize economies in times of economic crisis.

Building employment service capacity

If they work well, labour intermediation systems (e.g., job finding or employment services) are designed to help get workers into jobs and make transitions from work, employment and training. OECD research has amply identified employment/intermediation services as the most cost-effective active labour policy investment (Martin, 2006) with consistent findings for developing countries (Betcherman, Olivas and Dar, 2004). In OECD countries, many intermediation services also serve as the gateway for unemployment insurance and other social services (Mazza, 2003).

In a short-term crisis, the job-matching function of intermediation services cannot produce the same level of results owing to the falloff of new job listings. Such services have more often been used in Latin America in crisis times as a platform for labour interventions as they provide walk-in services via regional offices and maintain direct connections with local employers and workers. Investments in the short-term in such labour services, however, can pay dividends

⁸⁰ Includes 2009 extensions of eligibility in the United States (Inter-American Development Bank staff calculations in March 2009, based on unemployed populations relative to unemployment insurance programme recipients).

in the creation of more modern, efficient and flexible services once the economy recovers. Honduras, Mexico and Peru provide important examples of pursuing modernizations in the context of crises that serve to build labour market capacity in the medium-term, such as in reforms and service upgrading (e.g., computerization, quality control systems, staff training, mobile services for rural workers, electronic job banks), expanding connections with employers and focusing instruments on moving workers into higher quality jobs. The Mexican experience described in box 11.2 demonstrates how labour policy experimentation during the most recent crisis has led to the creation of more permanent instruments to deal with labour market contingencies.

Advancing labour training and human resources restructuring for firm competitiveness

In LAC, training is too often divorced from firm needs and conducted in an isolated fashion, separately from other human resource and technical changes within a firm. Another opportunity offered by economic crises is to pilot new methods of training or expand ones better linked to private sector demand, thus preparing for more competitive labour markets in better economic times. Mexico's former CIMO programme (*Calidad Integral y Modernización*) combined diagnostics of firms that identified what they needed to grow, be it marketing, training, design or restructuring. Training and technical assistance was then provided to implement the identified needs of the firm, specifically training related to implementing firm-level training with positive results for firm performance. While the piloted programme preceded the economic crisis, the programme was ready to be expanded and adapted during crisis times to work directly with affected employers. More systematic labour policy responses to economic crises can help to shift labour policy instruments to serve wider changes in how firms operate on a competitive basis.

Improving technical education and human capital formation

A key to future competitiveness of LAC lies in improving the quality of its human capital. The region now offers conditional cash transfers (CCTs) to the poor in nearly every country, in most countries tied to educational attendance and health indicators. However, CCTs are not instruments for the newly poor who often still have enough assets that they do not qualify for a CCT. While LAC countries have financed short-term training as policy responses to crises, little use has been made of education scholarships or investments in better technical education as part of the mix of policy responses to advance human capital. Instruments to improve the region's human capital base could include reform and modernization of technical education, creation of community colleges or technical colleges linked to local industries and service, university-level scholarships in high-demand skills for the unemployed, as well as curriculum reform to establish core

Box 11.2**Mexico's fast response "Preservation of Employment" programme becomes permanent to serve different types of crises**

Mexico was the Latin American country that suffered the most in the 2008-2009 period, experiencing both the financial crisis, the H1N1 influenza and dependence on U.S. markets. In January 2009, Mexico adapted an existing set of Ministry of Labour programmes to protect workers and expanded temporary work programmes under the Social Development Ministry. Under the umbrella project *Apoyo a la Preservación del Empleo* (Support to the Preservation of Employment) 47,525 workers benefitted from either temporary employment programmes or vouchers for training. In order to weather the tourism crisis and prevent mass layoffs or cutbacks in tip income (often the principal source of income for low-level workers), the Mexican government created the *Programa de Apoyo Emergente a Trabajadores del Sector Servicios* (Programme of Emerging Support to Social Sector Workers).

This programme provided 58,681 workers with up to two months of one or two minimum salaries. This programme evolved into the 2010 *Programa de Atención a Situaciones de Contingencia Laboral*, (Program for Attention to Labor Contingencies) a permanent program which offers a pre-set framework of instruments to be activated in case of an employment crisis. The federal programme was adapted in Ciudad Juarez to respond to the surge in youth violence. In Jalisco, along the beaches of the Pacific coast, the local government created its own version of the Federal programme, the *Programa Estatal Emergente de Capacitación para la Productividad* (Emerging State Program of Training for Productivity). Government, enterprises and workers in Jalisco agreed that employers would not dismiss its workers, while the government paid 55 per cent of workers' salaries for three months in government-provided training, and the employers paid 25 per cent (the remainder was absorbed by workers as a salary cut). More than any country in the region, Mexico has drawn on its network of state-based employment offices to adapt labour instruments to address short-term social and labour crises (Mexican Ministry of Labour, 2012).

competencies demanded across labour markets (e.g., communication, critical thinking, problem-solving and group work). Such rethinking of labour policy options would significantly expand the human capital value of policy responses.

Conclusions

LAC has had its share of experience in weathering economic crises. By all accounts, the region performed relatively well in the 2008-2010 financial crisis compared with past crises, with shorter-term impacts than many developed countries. Most countries in the region resumed a modest recovery in 2010.

As in the past, countries in the region strove to adapt existing labour market programmes and work rules and to initiate crisis-specific interventions. However, the crisis was perhaps not severe enough to motivate a rethinking of the use of

immediate measures versus more systematic measures as outlined in this chapter.

What explains the diversity of instruments and scale in this crisis? First, available funding was highly limited in the region, affecting which countries mounted responses. No country could marshal resources in the range of a United States-type stimulus programme. Second, labour policies and institutions were stronger in higher-income countries, giving them more flexibility when the crisis hit. Third, the diverse response can be partly explained by the heterogeneous impact of the crisis as outlined in the opening section on social and labour policy responses to the crisis. Mexico and countries where the impact was felt more strongly implemented more measures than, for instance, the Plurinational State of Bolivia, where export or tourism exposure was not as great. Finally, countries with lower institutional capacity (largely the poorer countries of Central America and the Caribbean) continue to be highly constrained in their capacity to respond to a crisis quickly and on a large scale.

The future challenge for the countries of LAC will be to create the capacity to implement systematic programmes that provide flexibility for future crises, but more importantly, lay the foundation for addressing the human capital priorities of the region. This would be a social safety net of both social and labour market programmes that promotes productivity—the most pressing labour market problem in the region—while protecting welfare in and out of a crisis. This means deploying a coherent mix of social and labour programmes that prevents welfare from falling below a minimum level but, at the same time, does not include instruments that distort employment growth towards less productive areas. The Latin American experience with crisis-driven employment programmes demonstrates the need for caution with some immediate types of interventions (such as temporary work programmes) in favour of more systematic measures that can be adapted as crises arise. Crises can yield institutional and policy legacies—laying the foundation for sound, market-driven active labour market policies that can lead the region to a more productive labour force in the future.

References

- Betcherman, Gordon, Karina Olivas and Amit Dar (2004). Impacts of active labor programs: New evidence from evaluations with particular attention to developing and transition countries. Social Protection Discussion Paper No. 0402 (January). Washington, D.C.: World Bank.
- Campos-Vazquez, Raymundo, and Horacio Sobarzo (2012). *The Development and Fiscal Effects of Emigration on Mexico*. Washington, D.C.: Woodrow Wilson International Center for Scholars and the Migration Policy Institute. April.
- Council on Foreign Relations (2008). Impact of the global financial crisis on developing nations. Seminar held on 12 December 2008 in New York.
- Department of Homeland Security (2010). Immigration enforcement actions: 2009. Washington, D.C.: Department of Homeland Security.
- Duryea, Suzanne, Jacqueline Mazza and Ferdinando Regalia (2009). *Social and Labour Market Policies for Tumultuous Times: Confronting the Global Crisis in Latin America and the Caribbean*. Washington, D.C.: Inter-American Development Bank.
- Economic Commission for Latin America (2006). *Shaping the Future of Social Protection: Access, Financing and Solidarity*. Santiago de Chile: ECLAC.
- ____ (2011). *Social Panorama of Latin America 2011*. Santiago de Chile: ECLAC.
- Galasso, Emanuela, and Martin Ravallion. (2003). Social protection in a crisis: Argentina's plan Jefes y Jefas. Policy Research Working Paper No. 3165. Washington, D.C.: World Bank.
- Gallego, Sonsoles, Sander Gardo, Reiner Martin, Luis Molina and Jose Maria Serena (2010). The impact of the global economic and financial crisis on Central Eastern and Southeastern Europe (CESEE) and Latin America. Banco de Espana Occasional Paper, No. 1002.
- González-Velosa, Carolina, Laura Ripani and David Rosas-Shady (2012). ¿Cómo mejorar las oportunidades de inserción laboral de los jóvenes en América Latina? Technical Notes, No. 305. Inter-American Development Bank. February.
- Ibarrarán, Pablo, and David Rosas Shady (2008). Evaluating the impact of job training programs in Latin America: Evidence from IDB funded observations. Washington, D.C.: Inter-American Development Office of Evaluation and Oversight. December.
- International Labour Organization and International Institute for Labour Studies (2011). *Brazil: an Innovative Income-Led Strategy*. Studies on Growth with Equity. Geneva, Switzerland.

- International Monetary Fund (2010). *Regional Economic Outlook: Western Hemisphere. Crisis Averted—What's Next?* Global Economic Prospects. Washington, D.C. October.
- Izquierdo, Alejandro, and Ernesto Talvi (2009). *Policy Trade-offs for Unprecedented Times: Confronting the Global Crisis in Latin America and the Caribbean*. Washington, D.C.: Inter-American Development Bank.
- Kluve, Jochen (2006). The Effectiveness of European Active Labor Market Policy. IZA Discussion Paper No. 2018. Bonn, Germany: Institute for the Study of Labor.
- Kostzer, Daniel (2008). Argentina: A Case Study on the Plan Jefes y Jefas de Hogar Desocupados, or the Employment Road to Economic Recovery. The Levy Economics Institute Working Paper No. 534. Annandale-on-Hudson, United States.
- Lustig, Nora (2000). [Crises and the Poor: Socially Responsible Macroeconomics](#). Inter-American Development Bank Technical Papers Series No. POV-108. Washington, D.C.: Inter-American Development Bank.
- Marinakís, Andrés, and Mario D. Velásquez (2010). Active Policies and the Economic Cycle. ILO Notes on the Crisis. Santiago de Chile: International Labour Office.
- Martin, John (2006). Globalization and Jobs: What Policies? *OECD Observer*, No. 256 (July). Organization for Economic Cooperation and Development.
- Mazza, Jacqueline (1999). Unemployment insurance: Case studies and lessons for Latin America and the Caribbean. RES Working Paper Series 411. Washington, D.C.: Inter-American Development Bank.
- ____ (2003). Labour intermediation services: Lessons for Latin American and the Caribbean, CEPAL Review No. 80. Santiago de Chile: Economic Commission for Latin America and the Caribbean.
- ____ (2009). Social and Labor Market Policies for Tumultuous Times. Presentation to the Second Meeting of the Working Groups of the XV Inter-American Conference of Ministries of Labor (IACML). Washington, D.C.: Organization of American States. 20 May.
- ____ (2011). Fast-Tracking Jobs: Advances and Next Steps in Labour Intermediation in Latin America and the Caribbean. Technical Notes No. 344. Washington, D.C.: Inter-American Development Bank.
- Mexican Ministry of Labour and Social Security, Employment Division (2012). Author interviews with Ministry officials, August 2012.
- Mosquera, Gioconda Herrera, María Isabel Moncayo and Alexandra Escobar García (2012). *Perfil Migratorio del Ecuador 2011*. Geneva: International Organization for Migration.

- Multilateral Investment Fund (2011). *Remittances to Latin America and the Caribbean in 2011: Regaining Growth*. Washington, D.C.: Multilateral Investment Fund, Inter-American Development Bank.
- Ninno, Carlo del, Kalanidhi Subbarao and Annamaria Milazzo (2009). How to Make Public Works Work: A Review of Experiences. Social Protection Discussion Paper 905 (May). Washington, D.C.: World Bank.
- Novacovsky, Irene, and Isidro Arduriz (2010). Políticas Sociales en Respuesta al Impacto de la Crisis Internacional en América Latina: Foro Virtual de los Ministerios Sociales de América Latina. Spain fund. United Nations Development Programme.
- Organization of American States, Organization for Economic Cooperation and Development and the Economic Commission for Latin America and the Caribbean (2011). *International Migration in the Americas 2011—First Report of the Continuous Reporting System on International Migration in the Americas* (SICREMI). Washington, D.C.: Organization of American States.
- Reinecke, Gerhard (2005). Income protection through direct employment programmes: Recent concepts and examples from Latin America. *International Social Security Review*, vol. 58, No. 2-3/2005 (July), pp. 163-183.
- Socio-Economic Database for Latin America and the Caribbean (2012). Poverty headcount ratio, based on official estimates. Available from <http://sedlac.econo.unlp.edu.ar/eng/> (accessed in 2012).
- Velásquez, Mario (2010). Políticas de protección social ante la crisis y para el crecimiento. Oficina Internacional del Trabajo (OIT), Notas Sobre la Crisis. Santiago de Chile.
- World Bank (n.d.). World Development Indicators database. Available from <http://data.worldbank.org/data-catalog/world-development-indicators>.

Chapter 12

Labour markets and the Arab spring: widening gaps among aspirations, capabilities and opportunities

AZITA BERAR

Introduction

The tragic self-immolation of Abdel-Aziz Bouazizi, a young educated Tunisian, whose repeated attempts to find a decent job and a livelihood were shattered, was more than a symbolic trigger of youth-led protests in several countries and territories in the Middle East and North Africa (MENA),⁸¹ commonly called the “Arab Spring”. It brought to the fore the more profound roots of protests embedded in the social and economic developments in the region and, in particular, the limited opportunities in labour markets.

While world attention to the Arab Spring, then and now, is primarily focused on the quest for democratic regimes, rights and political participation, this article focuses on the economic and labour market dimensions of the social and political upheavals in the MENA region. It shows that the economic strategies pursued in the countries in the region, hailed for achieving high economic growth by national and some international institutions, failed to deliver on jobs, particularly decent jobs. Moreover, the growth patterns did not have any significant impact on poverty and informality. The strategies pursued also did little by way of structural change in the economies of the region, or to create endogenous capabilities that would eventually underpin a high road to integration in the globalized world economy.

In fact, labour market trends in the MENA region over the last two decades

81 North Africa: Algeria, Egypt, Libya, Morocco, Sudan, Tunisia, Western Sahara. Middle East: Bahrain, Iraq, Israel, Jordan, Kuwait, Lebanon, Occupied Palestinian Territory, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates and Yemen.

show a widening gap between the aspirations and capabilities of a youthful population better educated than ever, and the opportunities available to them to obtain decent employment and to gain their rightful place in more inclusive societies. The “good” gross domestic product (GDP) growth performance and the proclaimed objectives of economic reforms that were set out in several countries in order to deliver better standards of living have not contributed to reducing this gap.

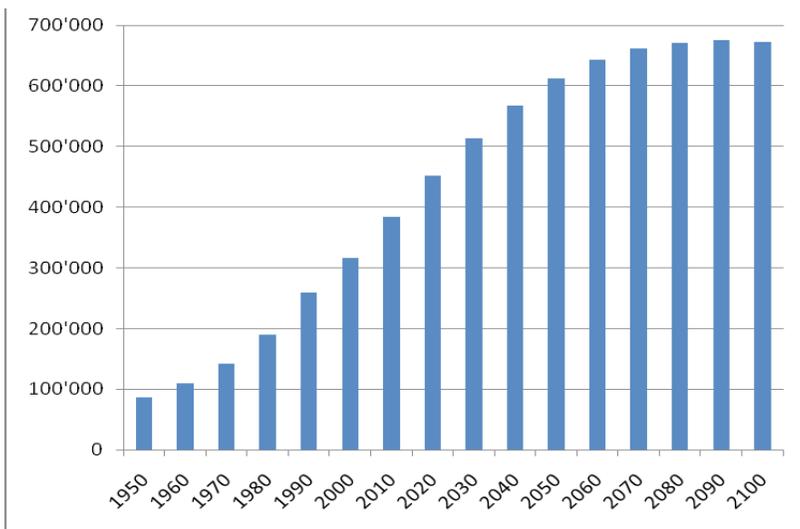
The analysis of key aspects of labour market dynamics in the region shows the need to give centre stage to quality job creation and to social justice.

Demographic dynamics and labour markets: the youth bulge

Demographic dynamics, the age composition of the labour force, the number of new entrants into the labour markets each year, and their educational and training profile are key determinants of labour supply and have a significant impact on labour markets. During the twentieth century, the MENA region experienced profound demographic changes and an unprecedented rapid population growth. The region’s population grew from 83 million around 1950 to approximately 382 million in 2010. According to the 2010 revision of United Nations population estimates and projections, the population will reach almost 700 million in 2090, at which time there will be a slight decline (figure 12.1).

The notable youth bulge is the result of sustained high fertility until the late

Figure 12.1 Total population in MENA (millions), 1950-2100



Source: United Nations (2010).

twentieth century. The significant decline in child mortality and the relatively slow decline in fertility initially led to an increase in the child population in the 1980s. The present youth bulge consists of the children born in the 1980s and early 1990s, who are now aged 15 to 24. Nearly one in five people is between the ages of 15 and 24. The size of the youth population in the region is unprecedented: over 85 million in 2010.

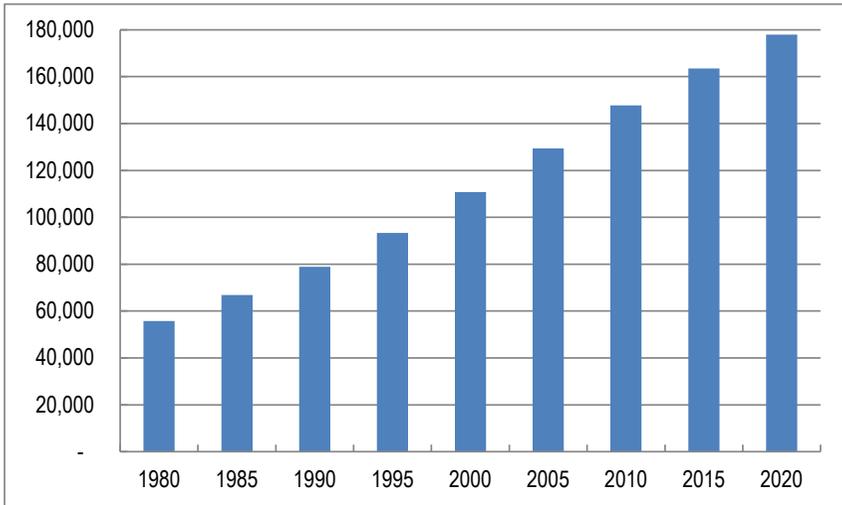
Given that countries are at different stages of a decline in fertility, the youth bulge will still rise in some countries and territories while it recedes in others. Over the next two decades, for example, the youth populations of high-fertility Iraq, Yemen, and the Occupied Palestinian Territory will see the fastest growth. On the other hand, countries already well into the transition to lower fertility—including Lebanon, Morocco and Turkey—will see their youth share decline between 2005 and 2025. The confluence of these trends will cause the youth population to peak in 2020 at about 98 million (Assaad and Roudi-Fahimi, 2007).

MENA is also one of the world's most urbanized regions and it is expected that urbanization will increase dramatically between now and 2050, partly because of persistent rural to urban migration (Berar, Fortuny and Awad, forthcoming). In general, unemployment rates are higher in urban than in rural areas, although there are important country differences. In Morocco, for example, unemployment is mainly an urban phenomenon, with more than 80 per cent of the unemployed population living in urban areas (Ibourk, 2012). Urban women are the most affected group, as revealed by their urban unemployment rates, which double the national average. The structure of active population by age shows that children and older people (over 60 years of age) are an important proportion of the labour force and the rural labour market is characterized by an early entry and a late exit. In this context, child labour and old age poverty are issues of concern (*ibid.*). Jordan illustrates the converse situation, where unemployment rates have traditionally been—and remain—higher in rural governorates, particularly for women.

Over the past fifty years, international migration has also played an important role in population change in the region. Economic expansion following the boom in oil revenues in the 1970s attracted millions of labour migrants, of all skill levels, especially to the Arabian Peninsula. Millions moved from labour-rich, non-oil-producing countries to seek jobs in the oil-rich countries within the region. Over time, as job opportunities diminished in the oil-rich countries, migration to Europe increased. Increasingly, lack of employment opportunities at home has become the driver of international labour migration.

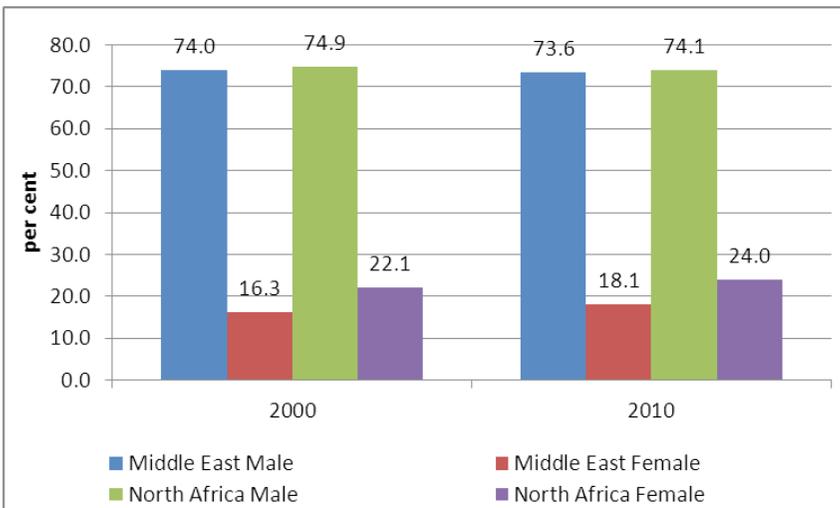
In sum, the timing and pattern of the region's demographic transition have had a significant effect on the dynamics of labour markets. This rapid labour force growth, with better education, improved health care and longer life expectancy, provides economies in the region with a large pool of creativity, innovation and productivity. The stark realities of economic and labour market developments in the past two decades have shown, however, that this potential is largely unrealized, and what is a demographic dividend is turning into a burden of unemployment and underemployment and low productivity jobs. The gaps among capabilities of the

Figure 12.2 Labour force (millions), 1980-2020



Source: International Labour Organization (2011a).

Figure 12.3 Gender gap in labour force participation, 2000 and 2010 (percentage)



Source: International Labour Organization (2011a).

young generation, their aspirations and opportunities offered have been widening.

Over the next two decades, the Middle East and North Africa region will face an unprecedented challenge. In 2010, the labour force of the region totalled some 146 million workers, and is expected to reach 162 million by 2015 and 176 million by 2020 (figure 12.2). Given this expansion, the economies of the region will need to create some 30 million new jobs in the next decade just to accommodate the new labour force entrants, without taking into account the backlog of the unemployed and those “discouraged” who have given up looking for jobs in the present circumstances.

Increased labour force participation: still too low, particularly for women

Labour force participation increased substantially between 1980 and 2005. This was mainly due to increases in female labour force participation rates, which had been below 20 per cent in most countries in 1980. Rising female labour participation during this period was one of the most important developments affecting the size and gender composition of the region’s labour force. From 2005 to 2011, however, labour force participation rates for both sexes remained practically constant, at around 47.5 per cent, and projections show that between now and 2020 they will remain the same or even decline slightly (this will be the case for Egypt, Libya and Morocco). Despite these trends, female participation rates remain at very low levels—below 25 per cent in the Middle East and below 30 per cent in North Africa. Figure 12.3 shows the wide gender gap that is closing all too slowly.

Lowest employment-to-population rates worldwide...

The MENA countries have the lowest employment-to-population rates in the world. In 2010, the estimated employment-to-population rate in the Middle East was 42.7 per cent and in North Africa it was 44.2 per cent, meaning that less than one out of two persons of working age actually worked (table 12.1). These rates have increased by only around 2 percentage points in the past ten years. In both regions the low employment-to-population rate is associated with low participation of women and youth in work. The female employment-to-population rate is about one third the male rate.

... and highest unemployment rate

Unemployment in the region is among the highest in the world. In North Africa, some progress has been made in reducing the unemployment rate in recent years, from a peak of 14.1 per cent in 2000 to 9.6 per cent in 2008, with economic

growth rates in the range of 4.5-6.5 per cent. The unemployment rate slightly increased with the economic crisis, and in 2010 it was estimated at 9.8 per cent.

The unemployment rate in the Middle East has remained relatively unchanged over the past ten years. During the years leading up to the global economic crisis, from 2004 to 2008, the unemployment rate had decreased by 1 percentage point, but the downward trend stagnated in 2008, and estimates for 2009 and 2010 show a steady rate of unemployment at 10.3 per cent. This continues to be the highest regional rate in the world, and only in North Africa was the unemployment rate nearing a similar level in 2010.

However, the impact of the global financial crisis on the Middle Eastern labour market is not adequately reflected in trends in the unemployment rate (International Labour Organization, 2011b). One of the reasons is that a large number of expatriates and migrant workers in the Gulf States have residence permits that are linked to employment contracts. When these workers are made redundant, they are more likely to return to their countries of origin and therefore drop out of the labour force of the country of destination, whereas migrant workers in Europe, for example, can often remain and “sit out the crisis” in the country of destination (Awad, 2009).

The most pressing challenges: tackling the youth employment crisis...

Several labour market indicators reflect the deep youth employment crisis in the region, including the number of job opportunities as well as the quality of jobs. Youth unemployment in MENA is the highest in the world (figure 12.4).

Youth labour force participation rates in the Middle East and North Africa remain among the lowest in the world (36.3 and 37.9 per cent, respectively) and they have decreased over time. The decline in youth labour force participation observed between 2000 and 2010 (table 12.2) reflects a decrease seen across all regions. In most regions, these declines apply to both young men and women. Participation rates for young women are much lower than for young men. In North Africa the youth female participation rate decreased faster than the male rate, leading to an increase in the gender gap.

The low and decreasing labour force participation of youth has not been the result of more young people engaging in education and prolonging their years of learning. Instead, it is associated with high and increasing rates of the inactive youth population, those who have detached themselves from the labour market (International Labour Organization, 2012). Amongst this composite group of “detached” or “discouraged” workers, a significant portion have withdrawn from the labour market and given up searching for work in view of the low expectations they have of finding a job that matches their qualifications or offers decent conditions of work. The educated, including university graduates, form a non-negligible segment of the disenchanting youth.

Table 12.1: Employment-to-population rate by gender (percentage)

Region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011a	2012a
Middle East													
Both	41.0	41.0	41.0	42.0	42.5	42.4	42.6	41.9	42.3	42.7	42.9	43.2	
Male	67.4	66.9	66.3	65.6	66.6	67.1	67.0	67.3	66.6	67.1	67.6	67.8	68.1
Female	13.2	13.4	13.7	14.3	15.0	15.3	15.1	15.1	14.3	14.5	14.8	15.0	15.2
North Africa													
Both	41.8	41.5	41.9	42.7	43.2	43.2	43.8	44.1	44.1	44.2	43.6	43.7	
Male	66.3	66.1	66.1	66.7	67.5	68.4	68.1	68.1	68.6	68.7	68.6	68.0	68.1
Female	17.5	17.2	16.7	17.4	18.2	18.2	18.6	19.8	19.9	19.8	20.0	19.6	19.8

Table 12.2: Youth labour force participation rates, 2000, 2010 and 2015 (percentage)

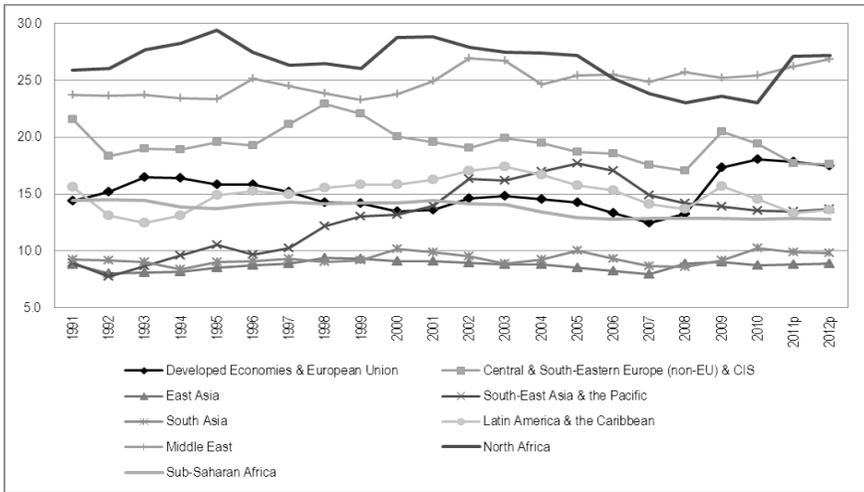
	Total youth					Male youth			Female Youth		
	2000	2010	2015a	2000	2010	2015	2000	2010	2015a		
Middle East	32.7	30.3	30.0	51.0	46.7	45.8	13.4	12.9	13.4		
North Africa	36.1	33.6	33.1	50.7	47.2	45.9	21.2	19.5	19.9		

Table 12.3: Youth employment, several indicators (2000, 2008 and 2011) and adult employment-to-population ratio (2011)

	Employed youth (thousands)			Youth employment-to-population ratio			Share of employment of young women amongst all young people employed			Adult employment-to-population ratio
	2000	2008	2011a	2000	2008	2011 a	2000	2008	2011 a	
Middle East	8,811	9,617	9,475	24.9	22.6	22.4	16.7		51.3	
North Africa	9,521	10,831	10,058	25.7	26.3	24.4	23.3		51.2	

Source: International Labour Organization (2011b).
 a Preliminary estimates.

Figure 12.4 Youth unemployment rate by region, 1991-2012 (percentage)



Source: International Labour Organization (2011b).

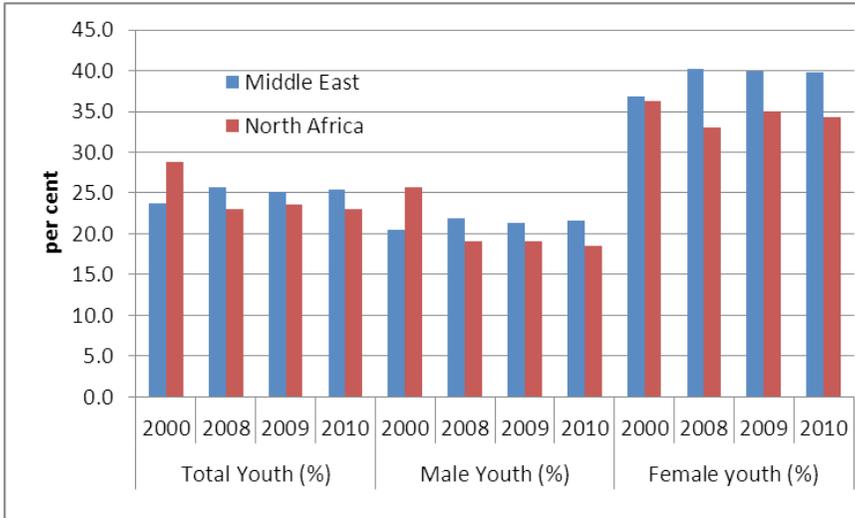
Note: Young people are defined as persons between the ages of 15 and 24.

Youth employment (see table 12.3) and unemployment also reveal a daunting picture. While 4 out of 10 male youths were working in 2008 (39.5 and 40.7 per cent in the Middle East and North Africa, respectively), less than 2 out of 10 young women were engaged in work (14.9 and 15.9 per cent, respectively).

Youth unemployment rates in the region are the highest in the world, with female youth unemployment surpassing male youth unemployment (figure 12.5). And youth unemployment is much higher than that of adults. In 2011, 6 out of 10 unemployed were young.

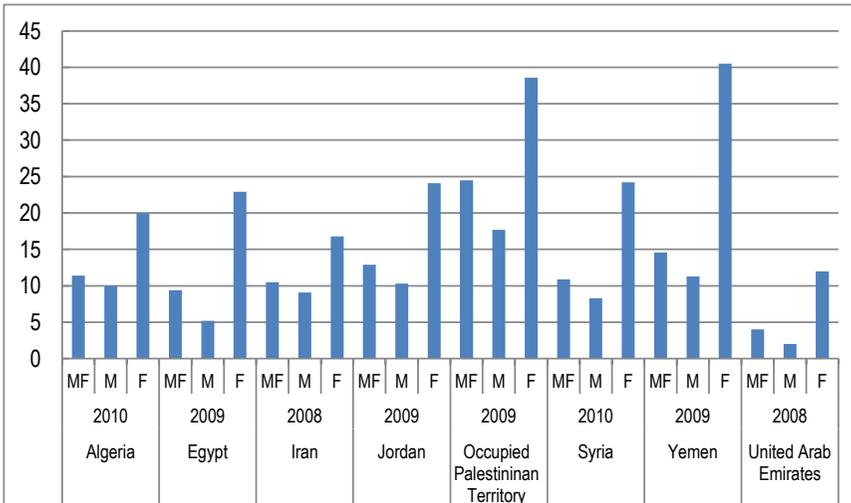
A closer analysis of youth school-to-work transition patterns shows that long unemployment durations are common among youth entering the labour market. For example, more than half of unemployed Syrian youth surveyed in 2005 had been searching for a job for more than one year. In Egypt, those between the ages of 20 and 24 reported searching for an average period of 34 months. For many, the state of prolonged unemployment reflects a mismatch between expectations and the quality of jobs available. In Egypt, the socioeconomic background of a young person affects the length of unemployment spells. Youth from middle-class, urban backgrounds are generally slower to enter the labour market than both the poor and the rich. These youth can afford to search longer for good jobs than the poor because they are able to depend more on family support than those from low-income family backgrounds. However, they lack the connections that wealthier youth can draw on to actually secure decent jobs. Young people from

Figure 12.5: Youth unemployment rate by gender, 2000 and 2008-2010 (percentage)



Source: International Labour Organization (2011b).

Figure 12.6 Unemployment rate by gender, selected countries, latest year available (percentage)



Source: International Labour Organization, Labour Force Surveys (LFS), various years; International Labour Organization (2011c).

Table 12.4: Unemployment rate by gender, 2000 and 2007-2011 (percentage)

		2000	2007	2008	2009	2010	2011 a	2012 a
Middle East	Both	10.5	10.3	10.4	10.1	9.9	10.2	10.3
	Male	8.8	8.4	8.6	8.2	8.1	8.3	8.4
	Female	18.9	18.6	18.9	18.7	18.5	18.7	18.6
North Africa	Both	13.6	10.1	9.6	9.6	9.6	10.9	11.0
	Male	11.5	8.1	7.5	7.3	7.4	8.2	8.4
	Female	20.8	16.1	16.0	16.5	16.4	19.0	18.9

Source: International Labour Organization (2011b),
a Preliminary estimates.

poor backgrounds are likely to enter the market more quickly, but often engage in lower-quality jobs at the expense of completing formal education (International Labour Organization, 2012).

...and closing the gender gap

With high rates of female inactivity, low participation and employment-to-population rates, women are particularly disadvantaged in availing themselves of opportunities in the labour market (table 12.4 and figure 12.6). For those who do look for work, the job search is long and difficult and oftentimes ultimately unsuccessful. This is reflected in the soaring female unemployment rates, twice as high as those of men, resulting in the highest gender gap in the world (International Labour Organization, 2012). In 2010 the female unemployment rate in the Middle East was estimated at 18.5 per cent and in North Africa at 16.4 per cent, compared with 8.1 and 7.4 per cent for their male counterparts.

Economic growth and reforms failed to deliver on employment opportunities, quality jobs and labour market inclusion

Between 1965 and 1985, the region's economic growth rates were among the highest in the world. In the mid-1980s, with the decline of oil prices, Governments initiated structural adjustment programmes with reforms that included privatization of State-owned enterprises, fiscal reform, trade liberalization and deregulation. By the early 1990s, a slow economic recovery had begun; however, the lack of economic diversification and export dependence made the region very vulnerable to trade shocks and oil price volatility. Furthermore, an extended drought that affected the region in the late 1990s caused a sharp drop in agricultural production. Between 1997 and 2007, the Middle East experienced solid GDP growth of an average of around 4.5 per cent per year. Economic growth was heightened

between 2003 and 2007, averaging approximately 6 per cent per year, the surge in the price of oil being the main driver.

In the second half of the past decade, North Africa also experienced remarkable growth, especially in 2006 and 2007, when GDP growth rates exceeded 6 per cent per year. In addition, the impact of the 2008 economic and financial crisis was less severe in the Middle East and North Africa than in other regions of the world. North Africa, in particular, was not strongly affected. This was due to the relative insulation of some economies in the region from global markets. The Middle East benefited from surplus liquidity built up from high oil prices.

Table 12.5 illustrates the large disparities in terms of GDP growth and GDP per capita between the oil-producing Gulf States and the rest.

In spite of the overall good growth performance, the reforms did not result in employment generation of the magnitude and type that can productively harness the human potential and the increasing demand for decent work, dignity and fairness in access to opportunities. Overall, employment growth remained far behind and to some extent disconnected from trends in economic growth (International Monetary Fund, n. d.; International Labour Organization, 2011b).

Jobs created were of low quality, whether we assess the quality in terms of productivity, ability to lift people out of poverty or the share of informal employment.

Working poverty and informality remain pervasive

MENA countries are generally regarded as having a relatively low incidence of income poverty. However, important challenges remain. In the Middle East, while the share of the working poor at the US\$ 1.25 per day level is small, working poverty at US\$ 2 per day is very significant (figures 12.7 and 12.8). During the 1990s, progress was made towards reducing the working poverty rate, but since the turn of the century, the decrease in this rate has been limited. In North Africa, working poverty at US\$ 2 a day has declined by 11 percentage points in the past 10 years. Over 30 per cent of the employed still live with their families on less than US\$ 2 a day and over 16 per cent do so on less than US\$ 1.25 a day. Lack of progress in reducing working poverty is linked to low labour productivity growth rates (figure 12.9).

Self-employment represents the major component of informal employment. It accounts for between one third and one half of total employment, except in Jordan, where it is closer to one fourth (Fortuny and Al Hussein, 2010). There is a tendency for informal paid employment to increase more rapidly than self-employment, a phenomenon which can be explained: either paid employment is growing in the microenterprise segment, or it is growing in the informal segment of medium and large enterprises of the formal sector, meaning a deterioration of the working conditions of wage earners. Most probably both dynamics are at work in most countries in the region. Informal employment in formal firms

Table 12.5 Annual real GDP growth rates, selected countries, 2005-2015 (percentage)

North Africa											
Algeria	5.1	2	3	2.4	2.4	3.8	4.0	4.1	4.1	4.1	2008
Egypt	4.5	6.8	7.1	7.2	4.6	5.2	5.5	5.7	5.9	6.2	2009
Libya	10.3	6.7	7.5	2.3	-2.3	10.6	6.2	6.4	7.4	7.7	2009
Morocco	2.9	7.7	2.7	5.6	4.9	4	4.3	4.9	4.9	4.9	2009
Tunisia	4	5.6	6.3	4.5	3.1	3.8	4.8	4.9	5.6	5.7	2006
Middle East											
Bahrain	7.8	6.6	8.4	6.3	3.1	3.9	4.5	4.8	4.8	4.9	2009
Iran (Islamic Republic of)	4.7	5.8	7.8	1.1	1.1	1.5	3.02	3.03	3.1	3.1	2008
Iraq	-0.8	6.2	1.5	9.5	4.2	2.6	11.4	11.3	10.1	11.1	2008
Jordan	8.1	7.9	8.5	7.6	2.3	3.4	4.2	5	5.5	5.5	2009
Kuwait	10.6	5.2	4.45	5.5	-4.8	2.3	4.4	5.1	5.2	5.3	2008
Lebanon	1	0.6	7.5	9.3	9	8	5	4	4	4	2007
Oman	3.9	5.5	6.8	12.8	3.6	4.7	4.7	4.1	4.0	4.2	2009
Qatar	7.6	18.6	26.7	25.4	8.6	15.9	18.6	9.3	4.6	4.9	2009
Saudi Arabia	5.5	3.1	2.1	4.23	0.6	3.4	4.5	4.4	4.46	4.6	2009
Sudan	6.3	11.3	10.2	6.8	4.5	5.5	6.2	6.2	5.1	5.4	2009
Syrian Arab Republic	4.5	5.1	4.2	5.2	3.9	4.9	5.5	5.6	5.6	5.6	2008
United Arab Emirates	8.2	8.7	6.1	5.2	-2.5	2.4	3.2	3.9	4.08	4.1	2008
Yemen	5.6	3.8	3.3	3.6	3.8	8.1	4.1	4.1	4.3	4.4	2008

Source: International Monetary Fund (n.d.), World Economic Outlook Database (accessed March 2011).

Table 12.6 Trends in productivity and wages, selected countries, 2000-2009

	Labour Productivity, GDP per person engaged (constant 1990 US dollars at PPP)			Growth, real average monthly wages				Growth, real minimum wage				Minimum wage PPP (US dollars), most recent year	Share of wage employment (2006 or latest available year)		
	2000	2007	2008	2000-2005	2007	2008	2009	2007	2008	2009	2007		2008	2009	Male	Female	All
Algeria	7831	8083	8051	-0.1	4.7	...	...	-3.4	-4.6	-5.4	308	61.9	49.8	59.8	2004
Egypt	11079	12680	13248	1.7	-0.8	...	...	-9.9	-10.5	-14	14	62.2	50.8	60.0	2005
Morocco	8056	9883	10200	...	0.8	1.7	5.2	-2	1	3.9	371	46.8	33.4	43.2	2006
Tunisia	13139	14998	15253	2.7	2.2	0	2.3	0.3	-0.3	-2.6	315	...	...	64.3	2003
Jordan	13310	15742	16016	0.6	3.4	-0.1	...	-5.1	-13	37.3	261	...	...	...	...
Saudi Arabia	27760	27881	28460	0.2	-1.7	...	...	-3.9	50.5	-1.2	...	...	...	...	...
Syrian Arab Republic	19204	17985	18107	...	-0.9	2.3	2.2	-4.5	-10.1	...	207	49.8	46.6	49.2	2001

Source: International Labour Organization (2008; 2010; 2011c).

Figure 12.7: Working Poverty at US\$ 2 a day, share in total employment, 1999-2011 (percentage)

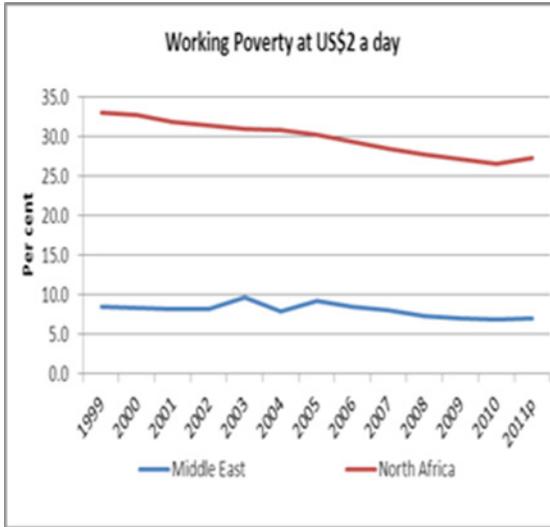
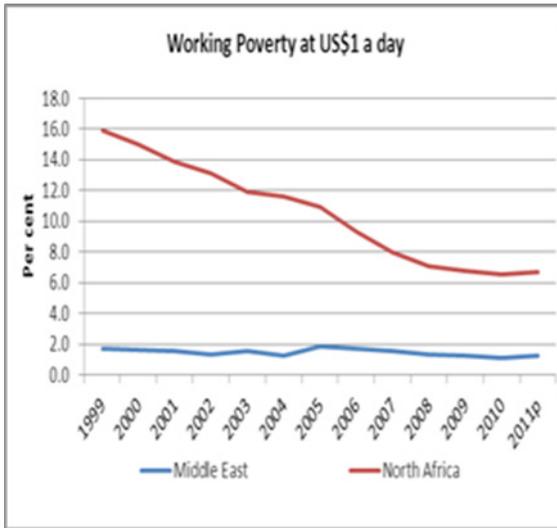
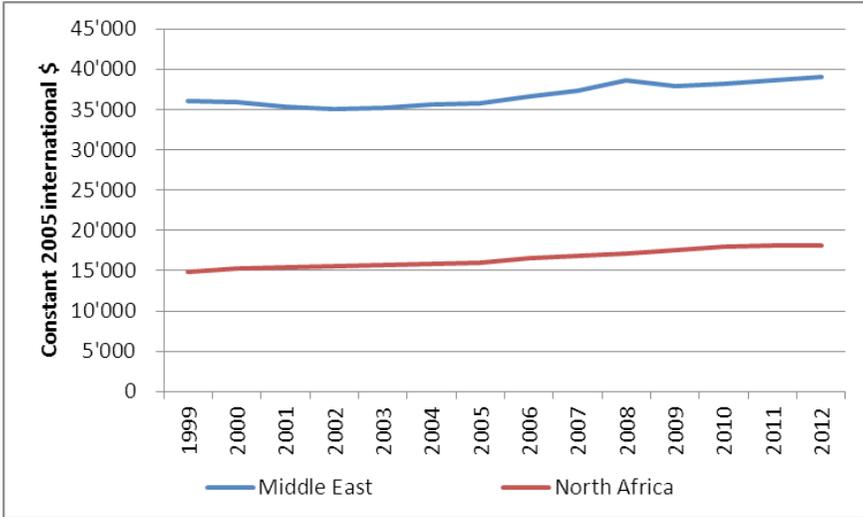


Figure 12.8: Working Poverty at US\$ 1.25 a day, share in total employment, 1999-2011 (percentage)



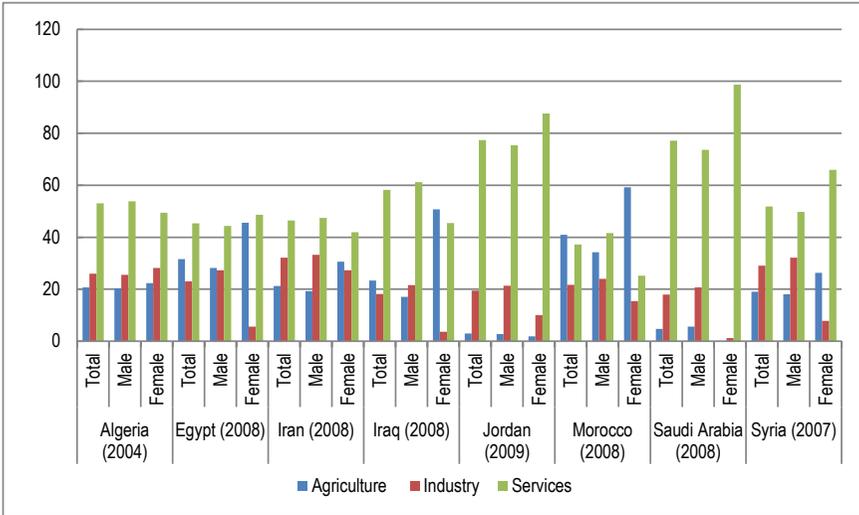
Source: International Labour Organization, (2011b).

Figure 12.9 Labour productivity—output per worker, 1999-2012 (constant 2005 international dollars)



Source: International Labour Organization (2011b).

Figure 12.10: Employment by sector, selected countries (percentage)



Source: International Labour Organization (2011c).

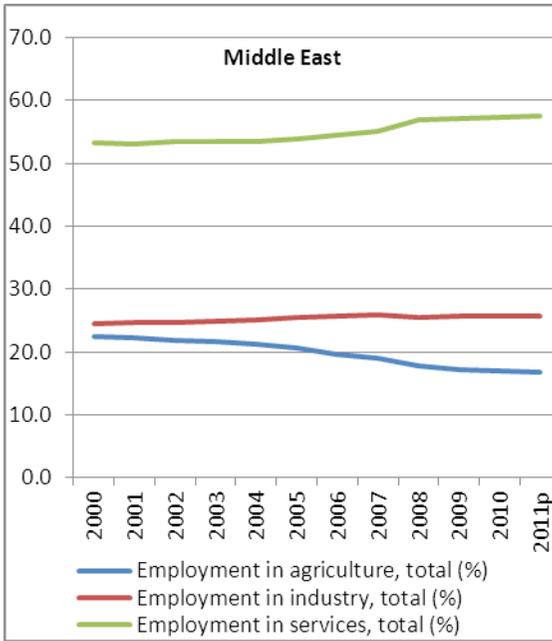


Figure 12.11:
Employment share by sector in the Middle East, 2000-2011 (percentage)

Source: International Labour Organization (2011b).

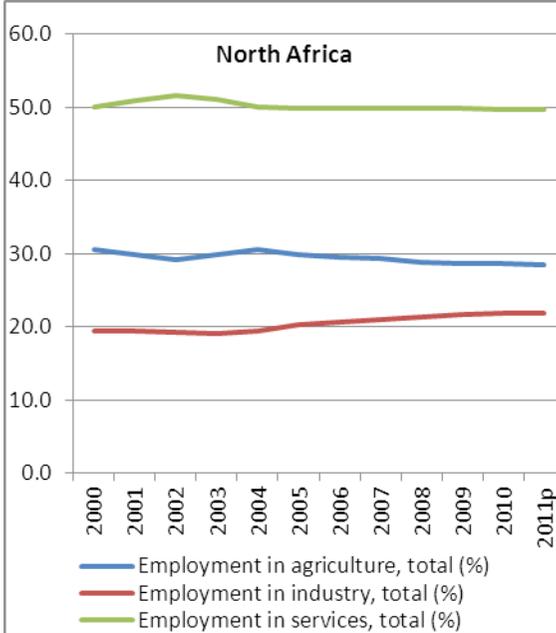


Figure 12.12:
Employment share by sector in North Africa, 2000-2011 (percentage)

Source: International Labour Organization (2011c).

is often linked with the development of export industries in free trade zones, through subcontracting of home-based workers or outworkers, particularly in textiles, garment or electronic appliances industries. Over the past decade, in Jordan, Morocco and Tunisia, subcontracting has taken on an important role in the economy.

Although the informal economy is generally an important source of employment for women in developing countries, in MENA, the proportion of men in informal employment exceeds that of women (Berar, Fortuny and Awad, forthcoming). However, among working women, the proportion of those working informally is generally much higher than for men. Patterns of employment by age show that both youth and older workers are more likely to be informally employed, as are the illiterate and the population below a secondary schooling level (*ibid.*).

The sectoral composition of employment also explains the high levels of informality. Although the sectoral composition of employment differs by country, as shown in figure 12.12, about half of the total employment is in the service sector, with this share remaining constant for the last decade (figures 12.10 and 12.11). The services sector typically covers heterogeneous activities with a small share of highly productive financial and banking sectors and mainly micro and small informal economy operators. The latter are the predominant source of jobs and livelihoods for large segments of the population in the Middle East and North Africa. The employment share in the agriculture sector (particularly in North Africa) is also quite substantial, and it has declined by about 2 percentage points in both North Africa and the Middle East.

The financial and privatization reforms implemented in several countries did not address the needs of the large pool of rural, urban informal and small operators, nor did they provide a level playing field for catalysing private sector development, including that of the small and medium-size enterprises.

In the past decade, countries began to reform and deregulate labour markets hoping to encourage employment. However, the lack of enforcement of legislation for new labour market entrants fostered informalization of labour markets well beyond self-employment and wage employment in small informal enterprises, to include unregulated employment in the formal private sector. Interestingly, in 2006, among the 52.6 per cent of informally employed, about 31 per cent were employed in the public sector, showing that public enterprises, too, have been offering low quality unprotected jobs (Berar, Fortuny and Awad, forthcoming).

Low productivity and low wages

Similarly, economic growth did not lift up low productivity, reflected in low wages.⁸² In the past decade, real wages either increased marginally or remained

82 Wage statistics in MENA are scarce and their quality is sometimes questionable.

stagnant (table 12.6). In the Middle East and North Africa, worker productivity, which should be a determinant of real wages, registered the lowest regional pace of growth during the 1990s, with the exception of Europe and Central Asia, which were undergoing significant economic restructuring. Between 2000 and 2008, worker productivity increased only marginally and, for example, declined in the Syrian Arab Republic. In Algeria and Egypt, there was a decline in real wages (figure 12.13).

The public–private divide

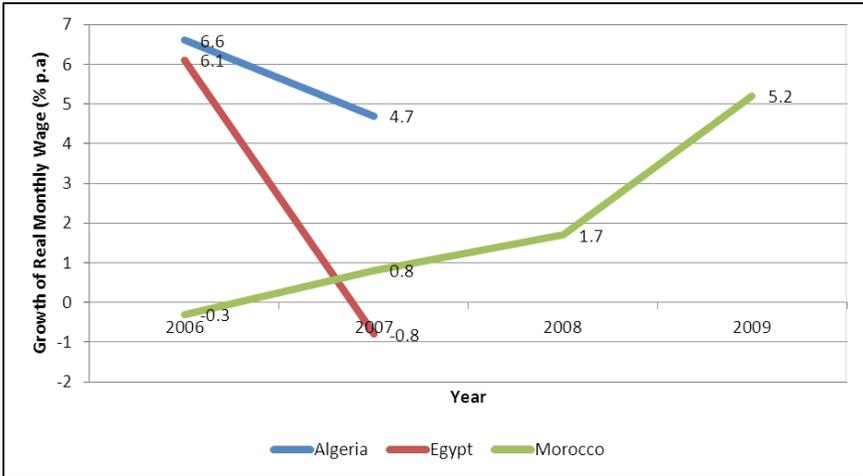
There has been much focus on the role of the public sector as the employer of first resort in the MENA region. The public sector, which in several countries offered near guaranteed employment for all educated workers, is still considered by many as the employer of first resort, offering better conditions of work. This is particularly attractive for women, who face less discrimination and harassment and can combine work and family responsibilities. However, employment in the public sector is not sustainable in the long term; several countries have already limited recruitment. It is true that the share of employment in the public sector is the highest in the world, and it can be affirmed that the public sector cannot play the role of job creator and guarantee employment for the young women and men entering the labour market.

However, an adequate strategy cannot lie solely in limiting the size and role of the public sector—as was attempted during the previous economic reforms—without offering real alternatives in the private sector. Many analysts suggest lowering the relatively better quality of employment, wages and conditions of work in the public sector as a solution to the duality in MENA labour markets. This chapter argues, in contrast, that the onus should be on reforms that create a true level playing field for a more inclusive and transparent private sector development and that offer a fairer deal to employees and workers. In a number of sectors, job vacancies remain in spite of high unemployment and discouragement.

In many countries, including in those that have advanced in their reform agendas and privatized significant segments of the economy, the decent jobs offered by the private sector’s rapid development are too few, and reserved for those with the right connections. A major turnaround is needed to improve the reality and the perceptions.

An agenda for the future

In sum, labour markets in the MENA region face significant challenges. There is an ever-widening gap between educational attainment, capabilities and aspirations of young generations of women and men and the opportunities available to them. There is a gap between much-acclaimed economic growth and the impact

Figure 12.13: Declining wage growth in Algeria and Egypt

Source: International Labour Organization (2010).

on people's lives. It is not surprising, therefore, that the quest for decent work, dignity, rights and social justice have been among the most pressing demands throughout the protests and the political transition processes. They are intimately intertwined with the quest for freedoms, rule of law and political participation.

Expectations are high for a better and fairer future. For that, the post-Arab Spring development agenda needs to project decent job creation as the overarching goal of new and alternative development strategies. Availability of quality employment opportunities for women and men who seek work and their impact on working poverty should become the main indicators against which to gauge the economic performance in the region. Alternative economic strategies and reforms that result in diversification, investment in infrastructure, science and innovation, and lead to structural transformation, are needed. Macroeconomic policies should not be solely concerned with stability and inflation-targeting but should also promote employment, ensure fiscal space for investing in labour market policies and human capital, and facilitate access to finance for the majority of economic operators. There is a strong case for investing in labour market institutions that can actively promote fairness and effectively reach out to the most vulnerable in the labour market to provide them with real options to improve their employability and with equal opportunities; and for building the capabilities of intermediary and democratic institutions, including freedom of association for workers and employers as partners for this new development agenda.

The road ahead may seem long and ambitious, the demands pressing and present. Action is needed now.

References

- Assaad, Ragui, and Farzaneh Roudi-Fahimi (2007). Youth in the Middle East and North Africa: Demographic opportunity or challenge? Population Reference Bureau. Available from <http://www.prb.org/pdf07/youthinMENA.pdf>.
- Awad, Ibrahim (2009). *The global economic crisis and migrant workers: Impact and response*. International Migration Programme. Geneva: International Labour Office.
- Berar, Azita, M. Fortuny and Ibrahim Awad (forthcoming). *Jobs, Freedom, Equality: An in-depth enquiry into the roots of uprisings in the Middle East and North Africa*. Geneva: International Labour Organization.
- Fortuny, Mariangels, and Jala Al Hussein (2010). Labour market policies and institutions: A synthesis report: The cases of Algeria, Jordan, Morocco, Syria and Turkey. Employment Sector, Employment Working Paper No. 64. Geneva: International Labour Organization.
- Ibourk, Aomar (2012). Contribution of labour market policies and institutions to employment, equal opportunities and the formalization of the informal economy: Morocco. Employment Sector, Employment Working Paper No. 123. Geneva: International Labour Organization.
- International Labour Organization (2008). *Global Wage Report 2008/09: Minimum wages and collective bargaining: Towards policy coherence*. Geneva: International Labour Office.
- _____ (2010). *Global Wage Report 2010/11: Wage policies in times of crisis*. Geneva: International Labour Office.
- _____ (2011a). Department of Statistics. Database of Labour Statistics (LABORSTA). Available from <http://laborsta.ilo.org/>.
- _____ (2011b). *Global Employment Trends 2011: The challenge of a jobs recovery*. Geneva: International Labour Office.
- _____ (2011c). Key Indicators of the Labour Market (KILM), 7th edition.
- _____ (2012). The youth employment crisis: time for action. Report V of the International Labour Conference, 101st session. Geneva. Available from http://www.ilo.org/wcmsp5/groups/public/@ed_norm/@relconf/documents/meetingdocument/wcms_175421.pdf.
- _____ (n.d.) Labour Force Surveys (LFS). Available from <http://www.ilo.org/dyn/lfsurvey/lfsurvey.home>.
- International Monetary Fund (n.d.). World Economic Outlook Database. Available from <http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx> (accessed 11 March 2011).
- United Nations (2010). *World Population Prospects: The 2010 Revision*. Preliminary results. New York: United Nations.

